

TUCSON ELECTRIC POWER CO  
Form 10-Q  
April 30, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended March 31, 2012

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission

Registrant; State of Incorporation;

File Number  
1-13739

Address; and Telephone Number  
**UNISOURCE ENERGY CORPORATION**

IRS Employer  
Identification Number  
86-0786732

(An Arizona Corporation)

88 E. Broadway Boulevard

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Tucson, AZ 85701

(520) 571-4000

1-5924

**TUCSON ELECTRIC POWER COMPANY**

86-0062700

(An Arizona Corporation)

88 E. Broadway Boulevard

Tucson, AZ 85701

(520) 571-4000

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.

UniSource Energy Corporation    Yes     No

Tucson Electric Power Company    Yes     No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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).

UniSource Energy Corporation    Yes     No

Tucson Electric Power Company    Yes     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):

UniSource Energy Corporation

Large Accelerated Filer     Accelerated Filer   
Non-accelerated Filer   
Smaller Reporting Company

Tucson Electric Power Company

Large Accelerated Filer     Accelerated Filer   
Non-accelerated Filer   
Smaller Reporting Company

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

UniSource Energy Corporation    Yes     No

Tucson Electric Power Company    Yes     No

As of April 18th, 2012, 40,260,270 shares of UniSource Energy Corporation Common Stock, no par value (the only class of Common Stock), were outstanding. As of April 18th, 2012, Tucson Electric Power Company had 32,139,434 shares of common stock outstanding, no par value, all of which were held by UniSource Energy Corporation.

This combined Form 10-Q is separately filed by UniSource Energy Corporation and Tucson Electric Power Company. Information contained in this document relating to Tucson Electric Power Company is filed by UniSource 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 UniSource 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 2012 first quarter report on Form 10-Q are defined below:

|                                  |   |
|----------------------------------|---|
| 1992 Mortgage                    | TEP's Indenture of Mortgage and Deed of trust, dated as of December 1, 1992, to the Bank of New York Mellon, successor trustee, as supplemented                                       |
| 2008 TEP Rate Order              | A rate order issued by the ACC resulting in a new retail rate structure for TEP, effective December 1, 2008   |
| 2010 TEP Reimbursement Agreement | Reimbursement Agreement, dated December 14, 2010, between TEP, as borrower, and a group of financial institutions   |
| ACC                              | Arizona Corporation Commission  |
| AFUDC                            | Allowance for Funds Used During Construction  |
| APS                              | Arizona Public Service Company  |
| 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 |
| BART                             | Best Available Retrofit Technology  |
| BHP                              | BHP Minerals International, Inc.  |
| BMGS                             | Black Mountain Generating Station   |
| Btu                              | British thermal unit(s)   |
| Capacity                         | The ability to produce power; the most power a unit can produce or the maximum that can be taken under a contract, measured in megawatts  |
| CCRs                             | Coal Combustion Residuals   |
| Circuit Court                    | United States Court of Appeals  |
| Common Stock Company             | UniSource Energy Corporation's common stock, without par value<br>UniSource Energy Corporation and its subsidiaries   |
| Convertible Senior Notes         | UniSource Energy Corporation's 4.5% Convertible Senior Notes  |
| Cooling Degree Days              | An index used to measure the impact of weather on energy usage calculated by subtracting 75 from the average of the high and low daily temperatures                                   |
| DSM                              | Demand Side Management  |
| EEIP                             | Energy Efficiency Implementation Plan   |
| Electric EE Standards            | Electric Energy Efficiency Standards  |
| Energy                           | The amount of power produced over a given period of time measured in Megawatt-hours   |
| EPA                              | Environmental Protection Agency   |
| EPS                              | Earnings Per Share  |
| FERC                             | Federal Energy Regulatory Commission  |
| FIP                              | Federal Implementation Plan   |
| 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)  |

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|                     |   |
|---------------------|---|
| 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  |
| kWh                 | Kilowatt-hour(s)  |
| LIBOR               | London Interbank Offered Rate   |
| Luna                | Luna Generating Station   |
| Millennium          | Millennium Energy Holdings, Inc., a wholly-owned subsidiary of UniSource 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   |
| O&M                 | Operations and Maintenance Expense  |
| NSP                 | Negotiated Sales Program  |
| NTUA                | Navajo Tribal Utility Authority   |



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|  |   |
|--|---|
| NO <sub>x</sub>                        | Nitrogen oxide  |
| PGA                                    | Purchased Gas Adjuster, a Retail Rate mechanism designed to recover the cost of gas purchased for retail gas customers  |
| PNM                                    | Public Service Company of New Mexico  |
| PNMR                                   | PNM Resources, Incorporated. PNM's parent company   |
| PPA                                    | Power Purchase Agreement  |
| PPFAC                                  | Purchased Power and Fuel Adjustment Clause  |
| PSD                                    | Prevention of Significant Deterioration   |
| RCRA                                   | Resource Conservation and Recovery Act  |
| RES                                    | Renewable Energy Standard   |
| 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      |
| San Juan                               | San Juan Generating Station   |
| SERP                                   | Supplemental Executive Retirement Plan  |
| SCR                                    | Selective Catalytic Reduction   |
| SES                                    | Southwest Energy Solutions, a wholly-owned subsidiary of Millennium   |
| SJCC                                   | San Juan Coal Company   |
| SMCRA                                  | Surface Mine Control and Reclamation Act  |
| SO <sub>2</sub>                        | 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  |
| Staff Accounting Bulletin 108          | Staff Accounting Bulletin No. 108 (ASC 250-10), Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements |
| Sundt                                  | H. Wilson Sundt Generating Station  |
| Sundt Unit 4                           | Unit 4 of the H. Wilson Sundt Generating Station  |
| TEP                                    | Tucson Electric Power Company, the principal subsidiary of UniSource 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 Letter of Credit Facility          | Letter of credit facility under the TEP Credit Agreement  |
| 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 UniSource Energy Corporation   |
| UES                                    |   |

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|                                  |  |
|----------------------------------|--|
|                                  | UniSource Energy Services, Inc., an intermediate holding company established to own the operating companies<br>UNS Gas and UNS Electric  |
| UniSource Credit<br>Agreement    | Second Amended and Restated Credit Agreement between UniSource Energy Corporation and a syndicate of<br>banks, dated as of November 9, 2010 (as amended)   |
| UniSource Energy                 | UniSource Energy Corporation   |
| UNS Electric                     | UNS Electric, Inc., a wholly-owned subsidiary of UES   |
| UNS Gas                          | UNS Gas, Inc., a wholly-owned subsidiary of UES  |
| UNS Gas/UNS Electric<br>Revolver | Revolving credit facility under the Second Amended and Restated Credit Agreement among UNS Gas and UNS<br>Electric as borrowers, UES as guarantor, and a syndicate of banks, dated as of November 9, 2010 (as amended) |

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders of

UniSource Energy Corporation:

We have reviewed the accompanying condensed consolidated balance sheet of UniSource Energy Corporation and its subsidiaries (the Company ) as of March 31, 2012, and the related condensed consolidated statements of income for the three-month periods ended March 31, 2012 and 2011, the condensed consolidated statements of comprehensive income for the three-month periods ended March 31, 2012 and 2011, the condensed consolidated statement of changes in stockholders' equity for the three-month period ended March 31, 2012 and the condensed consolidated statements of cash flows for the three-month periods ended March 31, 2012 and 2011. 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 as of December 31, 2011, and the related consolidated statements of income, of cash flows, of capitalization, and of changes in stockholders' equity and comprehensive income for the year then ended (not presented herein), and in our report dated February 27, 2012, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2011, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP  
PricewaterhouseCoopers LLP  
Phoenix, Arizona  
April 30, 2012

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholder of

Tucson Electric Power Company:

We have reviewed the accompanying condensed consolidated balance sheet of Tucson Electric Power Company and its subsidiaries (the Company ) as of March 31, 2012, and the related condensed consolidated statements of income (loss) for the three-month periods ended March 31, 2012 and 2011, the condensed consolidated statements of comprehensive income (loss) for the three-month periods ended March 31, 2012 and 2011, the condensed consolidated statement of changes in stockholder s equity for the three-month period ended March 31, 2012, and the condensed consolidated statements of cash flows for the three-month periods ended March 31, 2012 and 2011. 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 as of December 31, 2011, and the related consolidated statements of income, of cash flows, of capitalization, and of changes in stockholder s equity and comprehensive income for the year then ended (not present herein), and in our report dated February 27, 2012, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2011, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP  
PricewaterhouseCoopers LLP  
Phoenix, Arizona  
April 30, 2012

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## PART I FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## UNISOURCE ENERGY CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

|   | Three Months Ended<br>March 31, |            |
|---|---------------------------------|------------|
|   | 2012                            | 2011       |
|   | (Unaudited)                     |            |
|   | -Thousands of Dollars-          |            |
|   | (Except Per Share Amounts)      |            |
| <b>Operating Revenues</b>                           |                                 |            |
| Electric Retail Sales                               | \$ 205,431                      | \$ 217,215 |
| Electric Wholesale Sales                            | 37,104                          | 40,914     |
| Gas Retail Sales                                    | 50,209                          | 57,189     |
| Other Revenues                                      | 26,130                          | 29,448     |
| <b>Total Operating Revenues</b>                     | <b>318,874</b>                  | 344,766    |
| <b>Operating Expenses</b>                           |                                 |            |
| Fuel  | 70,735                          | 71,191     |
| Purchased Energy                                    | 63,276                          | 78,274     |
| Transmission  | 2,826                           | 2,502      |
| Decrease to Reflect PPFAC/PGA Recovery Treatment    | (2,561)                         | (5,388)    |
| <b>Total Fuel and Purchased Energy</b>              | <b>134,276</b>                  | 146,579    |
| Other Operations and Maintenance                    | 94,317                          | 101,056    |
| Depreciation  | 34,984                          | 32,790     |
| Amortization  | 8,664                           | 7,377      |
| Taxes Other Than Income Taxes                       | 12,238                          | 12,144     |
| <b>Total Operating Expenses</b>                     | <b>284,479</b>                  | 299,946    |
| <b>Operating Income</b>                             | <b>34,395</b>                   | 44,820     |
| <b>Other Income (Deductions)</b>                    |                                 |            |
| Interest Income                                     | 258                             | 994        |
| Other Income  | 3,095                           | 2,856      |
| Other Expense                                       | (458)                           | (629)      |
| <b>Total Other Income (Deductions)</b>              | <b>2,895</b>                    | 3,221      |
| <b>Interest Expense</b>                             |                                 |            |
| Long-Term Debt                                      | 19,135                          | 18,092     |
| Capital Leases                                      | 8,296                           | 9,929      |
| Other Interest Expense, Net of Interest Capitalized | 175                             | (920)      |
| <b>Total Interest Expense</b>                       | <b>27,606</b>                   | 27,101     |
| <b>Income Before Income Taxes</b>                   | <b>9,684</b>                    | 20,940     |

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|  |                 |                  |
|--|-----------------|------------------|
| Income Tax Expense   | 3,208           | 7,468            |
| <b>Net Income</b>  | <b>\$ 6,476</b> | <b>\$ 13,472</b> |
| <b>Weighted-Average Shares of Common Stock Outstanding (000)</b> |                 |                  |
| Basic  | 38,031          | 36,789           |
| Diluted  | 38,321          | 41,401           |
| <b>Earnings Per Share</b>  |                 |                  |
| Basic  | \$ 0.17         | \$ 0.37          |
| Diluted  | \$ 0.17         | \$ 0.35          |
| <b>Dividends Declared Per Share</b>                              | <b>\$ 0.43</b>  | <b>\$ 0.42</b>   |

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****UNISOURCE ENERGY CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

|   | Three Months Ended<br>March 31, |             |
|---|---------------------------------|-------------|
|   | <b>2012</b>                     | <b>2011</b> |
|   | <b>(Unaudited)</b>              |             |
|   | -Thousands of Dollars-          |             |
| <b>Comprehensive Income</b>   |                                 |             |
| Net Income  | <b>\$ 6,476</b>                 | \$ 13,472   |
| <b>Other Comprehensive Income (Loss)</b>  |                                 |             |
| Unrealized Gain (Loss) on Cash Flow Hedges, net of \$550, and \$(232) income taxes                              | <b>(839)</b>                    | 179         |
| Reclassification of Realized Losses on Cash Flow Hedges to Net Income, net of \$(544), and \$(105) income taxes | <b>831</b>                      | 161         |
| Supplemental Executive Retirement Plan (SERP) Benefit Adjustments, net of \$19, and \$0 income taxes            | <b>108</b>                      | 126         |
| <b>Total Other Comprehensive Income, Net of Income Taxes</b>  | <b>100</b>                      | 466         |
| <b>Total Comprehensive Income</b>   | <b>\$ 6,576</b>                 | \$ 13,938   |

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****UNISOURCE ENERGY CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

|  | Three Months Ended<br>March 31, |                  |
|--|---------------------------------|------------------|
|  | 2012                            | 2011             |
|  | (Unaudited)                     |                  |
|  | -Thousands of Dollars-          |                  |
| <b>Cash Flows from Operating Activities</b>                    |                                 |                  |
| Cash Receipts from Electric Retail Sales                       | \$ 240,164                      | \$ 252,545       |
| Cash Receipts from Electric Wholesale Sales                    | 43,034                          | 45,973           |
| Cash Receipts from Gas Retail Sales                            | 62,064                          | 67,327           |
| Cash Receipts from Operating Springerville Units 3 & 4         | 25,169                          | 26,345           |
| Interest Received  | 1,528                           | 3,653            |
| Performance Deposits Received                                  |                                 | 4,700            |
| Other Cash Receipts  | 6,841                           | 6,317            |
| Fuel Costs Paid  | (77,309)                        | (54,320)         |
| Purchased Energy Costs Paid                                    | (72,353)                        | (81,712)         |
| Payment of Other Operations and Maintenance Costs              | (70,427)                        | (76,626)         |
| Wages Paid, Net of Amounts Capitalized                         | (38,016)                        | (36,042)         |
| Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized | (31,952)                        | (31,593)         |
| Interest Paid, Net of Amounts Capitalized                      | (20,490)                        | (21,829)         |
| Capital Lease Interest Paid                                    | (19,369)                        | (22,721)         |
| Performance Deposits Paid                                      |                                 | (3,340)          |
| Other Cash Payments  | (2,314)                         | (1,838)          |
| <b>Net Cash Flows Operating Activities</b>                     | <b>46,570</b>                   | <b>76,839</b>    |
| <b>Cash Flows from Investing Activities</b>                    |                                 |                  |
| Return of Investments in Springerville Lease Debt              | 19,278                          | 38,353           |
| Insurance Proceeds for Replacement Assets                      | 2,875                           |                  |
| Other Cash Receipts  | 4,047                           | 2,468            |
| Capital Expenditures   | (78,931)                        | (88,611)         |
| Other Cash Payments  | (2,223)                         | (2,136)          |
| <b>Net Cash Flows Investing Activities</b>                     | <b>(54,954)</b>                 | <b>(49,926)</b>  |
| <b>Cash Flows from Financing Activities</b>                    |                                 |                  |
| Proceeds from Borrowings Under Revolving Credit Facilities     | 198,000                         | 101,000          |
| Proceeds from Issuance of Long-Term Debt                       |                                 | 11,080           |
| Other Cash Receipts  | 1,463                           | 2,435            |
| Repayments of Borrowings Under Revolving Credit Facilities     | (92,000)                        | (54,000)         |
| Payments of Capital Lease Obligations                          | (73,993)                        | (62,463)         |
| Common Stock Dividends Paid                                    | (16,322)                        | (15,406)         |
| Repayments of Long-Term Debt                                   | (8,448)                         | (1,064)          |
| Other Cash Payments  | (1,603)                         | (447)            |
| <b>Net Cash Flows Financing Activities</b>                     | <b>7,097</b>                    | <b>(18,865)</b>  |
| <b>Net Increase (Decrease) in Cash and Cash Equivalents</b>    | <b>(1,287)</b>                  | <b>8,048</b>     |
| <b>Cash and Cash Equivalents, Beginning of Year</b>            | <b>76,390</b>                   | <b>67,599</b>    |
| <b>Cash and Cash Equivalents, End of Period</b>                | <b>\$ 75,103</b>                | <b>\$ 75,647</b> |



See Note 11 for supplemental cash flow information.

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****UNISOURCE ENERGY CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS**

|   | March 31,<br>2012      | December 31,<br>2011 |
|---|------------------------|----------------------|
|   | (Unaudited)            |                      |
|   | -Thousands of Dollars- |                      |
| <b>ASSETS</b>   |                        |                      |
| <b>Utility Plant</b>                                  |                        |                      |
| Plant in Service                                      | \$ 4,877,759           | \$ 4,856,108         |
| Utility Plant Under Capital Leases                    | 582,669                | 582,669              |
| Construction Work in Progress                         | 113,306                | 89,749               |
| <b>Total Utility Plant</b>                            | <b>5,573,734</b>       | 5,528,526            |
| Less Accumulated Depreciation and Amortization        | (1,888,516)            | (1,869,300)          |
| Less Accumulated Amortization of Capital Lease Assets | (481,325)              | (476,963)            |
| <b>Total Utility Plant Net</b>                        | <b>3,203,893</b>       | 3,182,263            |
| <b>Investments and Other Property</b>                 |                        |                      |
| Investments in Lease Debt and Equity                  | 36,447                 | 65,829               |
| Other   | 34,987                 | 34,205               |
| <b>Total Investments and Other Property</b>           | <b>71,434</b>          | 100,034              |
| <b>Current Assets</b>                                 |                        |                      |
| Cash and Cash Equivalents                             | 75,103                 | 76,390               |
| Accounts Receivable - Customer                        | 77,365                 | 94,585               |
| Unbilled Accounts Receivable                          | 40,834                 | 51,464               |
| Allowance for Doubtful Accounts                       | (5,722)                | (5,572)              |
| Fuel Inventory  | 44,178                 | 33,263               |
| Materials and Supplies                                | 84,454                 | 82,649               |
| Derivative Instruments                                | 12,311                 | 11,966               |
| Regulatory Assets - Current                           | 116,509                | 97,056               |
| Deferred Income Taxes - Current                       | 21,721                 | 23,158               |
| Investments in Lease Debt                             | 9,831                  |                      |
| Other   | 31,174                 | 32,577               |
| <b>Total Current Assets</b>                           | <b>507,758</b>         | 497,536              |
| <b>Regulatory and Other Assets</b>                    |                        |                      |
| Regulatory Assets - Noncurrent                        | 166,111                | 173,199              |
| Other Assets  | 32,680                 | 32,199               |
| <b>Total Regulatory and Other Assets</b>              | <b>198,791</b>         | 205,398              |
| <b>Total Assets</b>                                   | <b>\$ 3,981,876</b>    | \$ 3,985,231         |

See Notes to Condensed Consolidated Financial Statements.

(Continued)



**Table of Contents****UNISOURCE ENERGY CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS**

|  | March 31,<br>2012      | December 31,<br>2011 |
|--|------------------------|----------------------|
|  | (Unaudited)            |                      |
|  | -Thousands of Dollars- |                      |
| <b>CAPITALIZATION AND OTHER LIABILITIES</b>                                    |                        |                      |
| <b>Capitalization</b>  |                        |                      |
| Common Stock Equity  | \$ 954,038             | \$ 888,474           |
| Capital Lease Obligations  | 275,198                | 352,720              |
| Long-Term Debt   | 1,446,720              | 1,517,373            |
| <b>Total Capitalization</b>  | <b>2,675,956</b>       | <b>2,758,567</b>     |
| <b>Current Liabilities</b>   |                        |                      |
| Current Obligations Under Capital Leases                                       | 86,051                 | 77,482               |
| Borrowing Under Revolving Credit Facilities                                    | 105,000                | 10,000               |
| Accounts Payable Trade   | 79,050                 | 109,759              |
| Interest Accrued   | 20,072                 | 38,302               |
| Accrued Taxes Other than Income Taxes  | 52,006                 | 41,997               |
| Accrued Employee Expenses  | 18,369                 | 24,917               |
| Customer Deposits  | 32,710                 | 32,485               |
| Regulatory Liabilities Current   | 43,843                 | 41,911               |
| Derivative Instruments   | 45,131                 | 36,467               |
| Other  | 5,686                  | 5,151                |
| <b>Total Current Liabilities</b>   | <b>487,918</b>         | <b>418,471</b>       |
| <b>Deferred Credits and Other Liabilities</b>                                  |                        |                      |
| Deferred Income Taxes Noncurrent   | 299,927                | 300,326              |
| Regulatory Liabilities Noncurrent  | 243,915                | 234,945              |
| Derivative Instruments   | 20,741                 | 20,403               |
| Pension and Other Postretirement Benefits                                      | 140,433                | 139,356              |
| Other  | 112,986                | 113,163              |
| <b>Total Deferred Credits and Other Liabilities</b>                            | <b>818,002</b>         | <b>808,193</b>       |
| <b>Commitments, Contingencies, and Proposed Environmental Matters (Note 6)</b> |                        |                      |
| <b>Total Capitalization and Other Liabilities</b>                              | <b>\$ 3,981,876</b>    | <b>\$ 3,985,231</b>  |

See Notes to Condensed Consolidated Financial Statements.

(Concluded)

**Table of Contents****UNISOURCE ENERGY CORPORATION****CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY**

|   | Common<br>Shares<br>Outstanding* | Common<br>Stock   | Accumulated<br>Earnings<br>(Unaudited) | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Stockholders<br>Equity |
|---|----------------------------------|-------------------|--|---|---------------------------------|
| -Thousands of Dollars-                                      |                                  |                   |  |   |                                 |
| <b>Balances at December 31, 2011</b>                        | <b>36,918</b>                    | <b>\$ 725,903</b> | <b>\$ 172,655</b>                      | <b>\$ (10,084)</b>                            | <b>\$ 888,474</b>               |
| Comprehensive Income  |                                  |                   |  |   |                                 |
| 2012 Year-to-Date Net Income                                |                                  |                   | 6,476                                  |   | 6,476                           |
| Other Comprehensive Income, net of \$25 income taxes        |                                  |                   |  | 100   | 100                             |
| <b>Total Comprehensive Income</b>                           |                                  |                   |  |   | <b>6,576</b>                    |
| Dividends, Including Non-Cash Dividend Equivalents          |                                  |                   | (16,406)                               |   | (16,406)                        |
| Shares Issued on Conversion of Notes and Related Tax Effect | 2,117                            | 74,448            |  |   | 74,448                          |
| Shares Issued for Stock Options                             | 12                               | 227               |  |   | 227                             |
| Shares Issued Under Performance Share Awards                | 31                               |                   |  |   |                                 |
| Other   |                                  | 719               |  |   | 719                             |
| <b>Balances at March 31, 2012</b>                           | <b>39,078</b>                    | <b>\$ 801,297</b> | <b>\$ 162,725</b>                      | <b>\$ (9,984)</b>                             | <b>\$ 954,038</b>               |

\* UniSource Energy has 75 million authorized shares of Common Stock.  
See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****TUCSON ELECTRIC POWER COMPANY****CONDENSED CONSOLIDATED STATEMENTS OF INCOME (LOSS)**

|   | Three Months Ended<br>March 31, |                 |
|---|---------------------------------|-----------------|
|   | 2012                            | 2011            |
|   | (Unaudited)                     |                 |
|   | -Thousands of Dollars-          |                 |
| <b>Operating Revenues</b>                           |                                 |                 |
| Electric Retail Sales                               | \$ 166,331                      | \$ 173,702      |
| Electric Wholesale Sales                            | 29,766                          | 35,256          |
| Other Revenues                                      | 27,881                          | 30,630          |
| <b>Total Operating Revenues</b>                     | <b>223,978</b>                  | <b>239,588</b>  |
| <b>Operating Expenses</b>                           |                                 |                 |
| Fuel  | 69,974                          | 70,369          |
| Purchased Power                                     | 13,626                          | 17,236          |
| Transmission  | 963                             | 695             |
| Decrease to Reflect PPFAC Recovery Treatment        | (7,686)                         | (8,937)         |
| <b>Total Fuel and Purchased Energy</b>              | <b>76,877</b>                   | <b>79,363</b>   |
| Other Operations and Maintenance                    | 82,466                          | 88,492          |
| Depreciation  | 27,467                          | 25,733          |
| Amortization  | 9,591                           | 8,304           |
| Taxes Other Than Income Taxes                       | 9,685                           | 9,904           |
| <b>Total Operating Expenses</b>                     | <b>206,086</b>                  | <b>211,796</b>  |
| <b>Operating Income</b>                             | <b>17,892</b>                   | <b>27,792</b>   |
| <b>Other Income (Deductions)</b>                    |                                 |                 |
| Interest Income                                     | 26                              | 734             |
| Other Income  | 2,461                           | 1,372           |
| Other Expense                                       | (1,487)                         | (1,230)         |
| <b>Total Other Income (Deductions)</b>              | <b>1,000</b>                    | <b>876</b>      |
| <b>Interest Expense</b>                             |                                 |                 |
| Long-Term Debt                                      | 13,916                          | 12,255          |
| Capital Leases                                      | 8,296                           | 9,929           |
| Other Interest Expense, Net of Interest Capitalized | 110                             | (747)           |
| <b>Total Interest Expense</b>                       | <b>22,322</b>                   | <b>21,437</b>   |
| <b>Income (Loss) Before Income Taxes</b>            | <b>(3,430)</b>                  | <b>7,231</b>    |
| Income Tax Expense (Benefit)                        | (1,969)                         | 2,527           |
| <b>Net Income (Loss)</b>                            | <b>\$ (1,461)</b>               | <b>\$ 4,704</b> |

See Notes to Condensed Consolidated Financial Statements.



**Table of Contents****TUCSON ELECTRIC POWER COMPANY****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

|   | Three Months Ended<br>March 31, |             |
|---|---------------------------------|-------------|
|   | <b>2012</b>                     | <b>2011</b> |
|   | <b>(Unaudited)</b>              |             |
|   | -Thousands of Dollars-          |             |
| <b>Comprehensive Income (Loss)</b>  |                                 |             |
| Net Income (Loss)   | <b>\$ (1,461)</b>               | \$ 4,704    |
| <b>Other Comprehensive Income (Loss)</b>  |                                 |             |
| Unrealized Gain (Loss) on Cash Flow Hedges, net of \$503, and \$(232) income taxes                              | <b>(768)</b>                    | 179         |
| Reclassification of Realized Losses on Cash Flow Hedges to Net Income, net of \$(528), and \$(105) income taxes | <b>806</b>                      | 161         |
| Supplemental Executive Retirement Plan (SERP) Benefit Adjustments, net of \$19, and \$0 income taxes            | <b>108</b>                      | 126         |
| <b>Total Other Comprehensive Income, Net of Income Taxes</b>  | <b>146</b>                      | 466         |
| <b>Total Comprehensive Income (Loss)</b>  | <b>\$ (1,315)</b>               | \$ 5,170    |

See Notes to Condensed Consolidated Financial Statements.



**Table of Contents****TUCSON ELECTRIC POWER COMPANY****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

|  | Three Months Ended<br>March 31, |                  |
|--|---------------------------------|------------------|
|  | 2012                            | 2011             |
|  | (Unaudited)                     |                  |
|  | -Thousands of Dollars-          |                  |
| <b>Cash Flows from Operating Activities</b>                    |                                 |                  |
| Cash Receipts from Electric Retail Sales                       | \$ 194,772                      | \$ 202,718       |
| Cash Receipts from Electric Wholesale Sales                    | 36,069                          | 40,583           |
| Cash Receipts from Operating Springerville Units 3 & 4         | 25,169                          | 26,345           |
| Reimbursement of Affiliate Charges                             | 6,988                           | 5,608            |
| Interest Received  | 1,523                           | 3,629            |
| Other Cash Receipts  | 4,719                           | 5,675            |
| Fuel Costs Paid  | (77,013)                        | (54,475)         |
| Payment of Other Operations and Maintenance Costs              | (69,497)                        | (74,687)         |
| Wages Paid, Net of Amounts Capitalized                         | (31,728)                        | (30,215)         |
| Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized | (22,299)                        | (21,387)         |
| Capital Lease Interest Paid                                    | (19,369)                        | (22,721)         |
| Purchased Power Costs Paid                                     | (13,019)                        | (13,607)         |
| Interest Paid, Net of Amounts Capitalized                      | (11,118)                        | (11,515)         |
| Other Cash Payments  | (3,646)                         | (2,788)          |
| <b>Net Cash Flows Operating Activities</b>                     | <b>21,551</b>                   | <b>53,163</b>    |
| <b>Cash Flows from Investing Activities</b>                    |                                 |                  |
| Return of Investments in Springerville Lease Debt              | 19,278                          | 38,353           |
| Insurance Proceeds for Replacement Assets                      | 2,875                           |                  |
| Other Cash Receipts  | 3,451                           | 1,958            |
| Capital Expenditures   | (66,845)                        | (65,747)         |
| Other Cash Payments  | (1,901)                         | (1,590)          |
| <b>Net Cash Flows Investing Activities</b>                     | <b>(43,142)</b>                 | <b>(27,026)</b>  |
| <b>Cash Flows from Financing Activities</b>                    |                                 |                  |
| Proceeds from Borrowings Under Revolving Credit Facility       | 120,000                         | 75,000           |
| Proceeds from Issuance of Long-Term Debt                       |                                 | 11,080           |
| Other Cash Receipts  | 377                             | 706              |
| Payments of Capital Lease Obligations                          | (73,993)                        | (62,435)         |
| Repayments of Borrowings Under Revolving Credit Facility       | (25,000)                        | (50,000)         |
| Repayments of Long-Term Debt                                   | (6,535)                         |                  |
| Other Cash Payments  | (1,504)                         | (292)            |
| <b>Net Cash Flows Financing Activities</b>                     | <b>13,345</b>                   | <b>(25,941)</b>  |
| <b>Net Increase (Decrease) in Cash and Cash Equivalents</b>    | <b>(8,246)</b>                  | <b>196</b>       |
| <b>Cash and Cash Equivalents, Beginning of Year</b>            | <b>27,718</b>                   | <b>19,983</b>    |
| <b>Cash and Cash Equivalents, End of Period</b>                | <b>\$ 19,472</b>                | <b>\$ 20,179</b> |

See Note 11 for supplemental cash flow information.

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****TUCSON ELECTRIC POWER COMPANY****CONDENSED CONSOLIDATED BALANCE SHEETS**

|   | March 31,<br>2012      | December 31,<br>2011 |
|---|------------------------|----------------------|
|   | (Unaudited)            |                      |
|   | -Thousands of Dollars- |                      |
| <b>ASSETS</b>   |                        |                      |
| <b>Utility Plant</b>                                  |                        |                      |
| Plant in Service                                      | \$ 4,239,444           | \$ 4,222,236         |
| Utility Plant Under Capital Leases                    | 582,669                | 582,669              |
| Construction Work in Progress                         | 94,539                 | 76,517               |
| <b>Total Utility Plant</b>                            | <b>4,916,652</b>       | 4,881,422            |
| Less Accumulated Depreciation and Amortization        | (1,768,412)            | (1,753,807)          |
| Less Accumulated Amortization of Capital Lease Assets | (481,325)              | (476,963)            |
| <b>Total Utility Plant Net</b>                        | <b>2,666,915</b>       | 2,650,652            |
| <b>Investments and Other Property</b>                 |                        |                      |
| Investments in Lease Debt and Equity                  | 36,447                 | 65,829               |
| Other   | 33,078                 | 32,313               |
| <b>Total Investments and Other Property</b>           | <b>69,525</b>          | 98,142               |
| <b>Current Assets</b>                                 |                        |                      |
| Cash and Cash Equivalents                             | 19,472                 | 27,718               |
| Accounts Receivable - Customer                        | 56,985                 | 71,435               |
| Unbilled Accounts Receivable                          | 28,479                 | 32,386               |
| Allowance for Doubtful Accounts                       | (3,799)                | (3,766)              |
| Accounts Receivable - Due from Affiliates             | 2,697                  | 4,049                |
| Fuel Inventory  | 43,895                 | 32,981               |
| Materials and Supplies                                | 72,495                 | 70,749               |
| Regulatory Assets - Current                           | 90,594                 | 71,747               |
| Deferred Income Taxes - Current                       | 21,018                 | 21,678               |
| Investments in Lease Debt                             | 9,831                  |                      |
| Other   | 14,956                 | 15,192               |
| <b>Total Current Assets</b>                           | <b>356,623</b>         | 344,169              |
| <b>Regulatory and Other Assets</b>                    |                        |                      |
| Regulatory Assets - Noncurrent                        | 150,885                | 157,386              |
| Other Assets  | 25,884                 | 25,135               |
| <b>Total Regulatory and Other Assets</b>              | <b>176,769</b>         | 182,521              |
| <b>Total Assets</b>                                   | <b>\$ 3,269,832</b>    | \$ 3,275,484         |

See Notes to Condensed Consolidated Financial Statements.

(Continued)



**Table of Contents****TUCSON ELECTRIC POWER COMPANY****CONDENSED CONSOLIDATED BALANCE SHEETS**

|  | March 31,<br>2012      | December 31,<br>2011 |
|--|------------------------|----------------------|
|  | (Unaudited)            |                      |
|  | -Thousands of Dollars- |                      |
| <b>CAPITALIZATION AND OTHER LIABILITIES</b>                                    |                        |                      |
| <b>Capitalization</b>  |                        |                      |
| Common Stock Equity  | \$ 823,628             | \$ 824,943           |
| Capital Lease Obligations  | 275,198                | 352,720              |
| Long-Term Debt   | 1,073,858              | 1,080,373            |
| <b>Total Capitalization</b>  | <b>2,172,684</b>       | <b>2,258,036</b>     |
| <b>Current Liabilities</b>   |                        |                      |
| Current Obligations Under Capital Leases                                       | 86,051                 | 77,482               |
| Borrowing Under Revolving Credit Facility                                      | 105,000                | 10,000               |
| Accounts Payable Trade   | 60,318                 | 84,508               |
| Accounts Payable Due to Affiliates   | 3,540                  | 4,827                |
| Interest Accrued   | 17,834                 | 30,877               |
| Accrued Taxes Other than Income Taxes  | 40,140                 | 32,155               |
| Accrued Employee Expenses  | 15,684                 | 21,356               |
| Customer Deposits  | 23,674                 | 23,743               |
| Derivative Instruments   | 14,832                 | 9,040                |
| Regulatory Liabilities Current   | 22,077                 | 23,702               |
| Other  | 4,792                  | 4,524                |
| <b>Total Current Liabilities</b>   | <b>393,942</b>         | <b>322,214</b>       |
| <b>Deferred Credits and Other Liabilities</b>                                  |                        |                      |
| Deferred Income Taxes Noncurrent   | 261,651                | 263,225              |
| Regulatory Liabilities Noncurrent  | 208,446                | 200,599              |
| Derivative Instruments   | 14,336                 | 14,142               |
| Pension and Other Postretirement Benefits                                      | 131,687                | 130,660              |
| Other  | 87,086                 | 86,608               |
| <b>Total Deferred Credits and Other Liabilities</b>                            | <b>703,206</b>         | <b>695,234</b>       |
| <b>Commitments, Contingencies, and Proposed Environmental Matters (Note 6)</b> |                        |                      |
| <b>Total Capitalization and Other Liabilities</b>                              | <b>\$ 3,269,832</b>    | <b>\$ 3,275,484</b>  |

See Notes to Condensed Consolidated Financial Statements.

(Concluded)

**Table of Contents****TUCSON ELECTRIC POWER COMPANY****CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDER'S EQUITY**

|   | Common<br>Stock        | Capital<br>Stock<br>Expense | Accumulated<br>Deficit<br>(Unaudited) | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Stockholder's<br>Equity |
|---|------------------------|-----------------------------|---------------------------------------|---|----------------------------------|
|   | -Thousands of Dollars- |                             |                                       |   |                                  |
| <b>Balances at December 31, 2011</b>                  | <b>\$ 888,971</b>      | <b>\$ (6,357)</b>           | <b>\$ (47,627)</b>                    | <b>\$ (10,044)</b>                            | <b>\$ 824,943</b>                |
| Comprehensive Income (Loss)                           |                        |                             |                                       |   |                                  |
| 2012 Year-to-Date Net Loss                            |                        |                             | (1,461)                               |   | (1,461)                          |
| Other Comprehensive Income, net of \$(6) income taxes |                        |                             |                                       | 146   | 146                              |
| <b>Total Comprehensive Loss</b>                       |                        |                             |                                       |   | <b>(1,315)</b>                   |
| <b>Balances at March 31, 2012</b>                     | <b>\$ 888,971</b>      | <b>\$ (6,357)</b>           | <b>\$ (49,088)</b>                    | <b>\$ (9,898)</b>                             | <b>\$ 823,628</b>                |

See Notes to Condensed Consolidated Financial Statements.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Unaudited**

**NOTE 1. NATURE OF OPERATIONS AND BASIS OF ACCOUNTING PRESENTATION**

UniSource Energy Corporation (UniSource Energy) is a utility services holding company engaged, through its subsidiaries, in the electric generation and energy delivery business. Each of UniSource Energy's subsidiaries is a separate legal entity with its own assets and liabilities. UniSource Energy owns 100% of Tucson Electric Power Company (TEP), UniSource Energy Services, Inc. (UES), Millennium Energy Holdings, Inc. (Millennium), and UniSource Energy Development Company (UED).

TEP is a regulated public utility and UniSource Energy's largest operating subsidiary, representing approximately 82% of UniSource Energy's total assets as of March 31, 2012. TEP generates, transmits and distributes electricity to approximately 405,000 retail electric customers in a 1,155 square mile area in southeastern Arizona. TEP also sells electricity to other utilities and power marketing entities, located primarily in the western U.S. In addition, TEP operates Springerville Unit 3 on behalf of Tri-State Generation and Transmission Association, Inc. (Tri-State) and Springerville Unit 4 on behalf of Salt River Project Agricultural Improvement and Power District (SRP).

UES holds the common stock of two regulated public utilities, UNS Gas, Inc. (UNS Gas) and UNS Electric, Inc. (UNS Electric). UNS Gas is a regulated gas distribution company, which services approximately 148,000 retail customers in Mohave, Yavapai, Coconino, and Navajo counties in northern Arizona, as well as in Santa Cruz County in southern Arizona. UNS Electric is a regulated public utility, which generates, transmits and distributes electricity to approximately 92,000 retail customers in Mohave and Santa Cruz counties. In July 2011, UNS Electric purchased Black Mountain Generating Station (BMGS) from UED. This transaction did not impact UniSource Energy's consolidated financial statements.

UED currently has no significant remaining assets.

Millennium's investments in unregulated businesses represent less than 1% of UniSource Energy's assets as of March 31, 2012.

References to we and our are to UniSource Energy and its subsidiaries, collectively.

The accompanying quarterly financial statements of UniSource Energy and TEP are unaudited but reflect all normal recurring accruals and other adjustments which we believe are necessary for a fair presentation of the results for the interim periods presented. These financial statements are presented in accordance with the Securities and Exchange Commission's interim reporting requirements which do not include all the disclosures required by generally accepted accounting principles (GAAP) in the United States of America for audited annual financial statements. UniSource Energy and TEP reclassified certain amounts in the financial statements to conform to current year presentation. The year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. This quarterly report should be reviewed in conjunction with UniSource Energy's and TEP's 2011 Annual Report on Form 10-K.

Because weather and other factors cause seasonal fluctuations in sales of TEP, UNS Gas, and UNS Electric, quarterly results are not indicative of annual operating results.

**REVISION OF PRIOR PERIOD FINANCIAL STATEMENTS**

In 2011, we identified errors related to amounts recorded as owed to or payable by TEP for electricity deliveries settled in-kind or to be settled in-kind during prior years under our transmission, interconnection and certain joint operating agreements. Separately, in 2011, we identified errors in the calculation of income tax expense, in prior years, arising from not treating a portion of the Allowance for Funds Used During Construction, as a permanent book to tax difference.

We assessed the materiality of these errors on prior period financial statements and concluded they were not material to any prior annual or interim periods, but the cumulative impact, if recognized in 2011, would have been material to the results in 2011. As a result, in accordance with Staff Accounting Bulletin 108, we revised our prior period financial statements to correct these errors.

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**

The revision and reclassifications impacted statements of income and balance sheets as shown in the tables below:

|  | UniSource Energy                     |            | TEP         |            |
|--|--------------------------------------|------------|-------------|------------|
|  | As Reported                          | As Revised | As Reported | As Revised |
|  | Three Months Ended<br>March 31, 2011 |            |             |            |
|  | -Thousands of Dollars-               |            |             |            |
|  | (Except Per Share Amounts)           |            |             |            |
| <b><u>Income Statement</u></b>                   |                                      |            |             |            |
| Electric Wholesale Sales                         | \$ 40,781                            | \$ 40,914  | \$ 35,122   | \$ 35,256  |
| Fuel   | 72,137                               | 71,191     | 71,315      | 70,369     |
| Purchased Energy                                 | 77,640                               | 78,274     | 16,601      | 17,236     |
| Decrease to Reflect PPFAC/PGA Recovery Treatment | (5,793)                              | (5,388)    | (9,342)     | (8,937)    |
| Income Tax Expense                               | 3,909                                | 7,468      | 208         | 2,527      |
| Net Income                                       | 16,992                               | 13,472     | 6,983       | 4,704      |
| Basic EPS  | 0.46                                 | 0.37       | N/A         | N/A        |
| Diluted EPS                                      | 0.44                                 | 0.35       | N/A         | N/A        |
| <b><u>Balance Sheet</u></b>                      |                                      |            |             |            |
| Deferred Income Taxes Current                    | 35,210                               | 30,989     | 36,205      | 31,985     |
| Accounts Receivable Customer                     | 73,350                               | 88,050     | 53,560      | 68,259     |
| Regulatory Assets Noncurrent                     | 191,238                              | 186,812    | 180,723     | 176,296    |
| Common Stock Equity                              | 824,127                              | 830,577    | 708,604     | 715,054    |
| Accounts Payable Trade                           | 97,260                               | 96,862     | 71,276      | 70,879     |

**RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS**

The Financial Accounting Standards Board issued authoritative guidance that eliminated the option to report other comprehensive income in the statement of changes in equity. Rather, an entity must elect to present items of net income and other comprehensive income in one continuous statement or in two separate but consecutive statements. Effective in the first quarter of 2012, we elected to include separate statements of comprehensive income (loss) with our financial statements.

We implemented accounting guidance in the first quarter of 2012 which enhances our disclosures regarding unobservable inputs in calculating the fair market value of certain assets and liabilities. The guidance requires additional quantitative and qualitative analysis of inputs when we use significant unobservable inputs to measure the fair value of our derivatives and financial instruments. See Note 9.

**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 used by 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.



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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**

**UNS GAS RATE CASE**

In April 2011, UNS Gas filed a general rate case (on a cost-of-service basis) with the ACC requesting a Base Rate increase of 3.8% to cover a revenue deficiency of \$5.6 million.

In April 2012, the ACC approved a Base Rate increase of \$2.7 million as well as a mechanism to enable UNS Gas to recover lost fixed-cost revenues as a result of implementing the ACC's Gas Energy Efficiency Standards. No accounting adjustment is anticipated as a result of the approval. The new rates will be effective on May 1, 2012.

**COST RECOVERY MECHANISMS**

**TEP Purchased Power and Fuel Adjustment Clause**

In March 2012, the ACC approved a 0.77 cents per Kilowatt-hour (kWh) Purchased Power and Fuel Adjustment Clause (PPFAC) rate, effective April 2012. The PPFAC rate for the prior 12-month period was 0.53 cents per kWh. As a result of the new PPFAC rate, in the first quarter of 2012 TEP moved the entire \$15 million of under-collected costs from Regulatory Assets - Noncurrent to Regulatory Assets - Current. At March 31, 2012, TEP had under-collected fuel and purchased power costs on a billed-to-customers basis of \$57 million, an increase of \$8 million from December 31, 2011.

**UNS Gas Purchased Gas Adjustor**

In April 2012, the ACC approved a Purchased Gas Adjustor (PGA) temporary credit of 4.5 cents per therm, effective May 2012 through April 2014. At March 31, 2012, the PGA bank balance was over-collected by \$14 million on a billed-to-customers basis.

**ELECTRIC ENERGY EFFICIENCY STANDARDS**

In January 2012, TEP filed a modification to its proposed 2011-2012 Energy Efficiency Implementation Plan (EEIP) with the ACC. The modification includes a request for an increase in the performance incentive in order for TEP to meet the Electric Energy Efficiency Standards targets for 2012 and for 2013. TEP proposed annual performance incentives range from \$6 million to \$8 million each year for 2012 and 2013. In March 2012, the ACC voted to send this matter to a hearing in order to gather more information. An ACC administrative law judge is expected to issue a procedural order for this matter. TEP cannot predict when the ACC will issue a final ruling on the EEIP.

**NOTE 3. BUSINESS SEGMENTS**

We have three reportable segments that are determined based on the way we organize our operations and evaluate performance:

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

Results for the UniSource Energy and UES holding companies, Millennium and UED are included in Other below.

We accounted for UNS Electric's purchase of BMGS in accordance with accounting rules related to the transfer of a business held under common control. For the three months ended March 31, 2011, UNS Electric's net income increased by \$1 million; the increase was offset by reconciling adjustments. The transaction had no impact on UniSource Energy's consolidated financial statements.

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**

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

|   | Reportable Segments         |            |                 |       |                            | UniSource<br>Energy<br>Consolidated |
|---|-----------------------------|------------|-----------------|-------|----------------------------|-------------------------------------|
|   | TEP                         | UNS<br>Gas | UNS<br>Electric | Other | Reconciling<br>Adjustments |                                     |
| -Millions of Dollars-                     |                             |            |                 |       |                            |                                     |
| <b>Income Statement</b>                   |                             |            |                 |       |                            |                                     |
| <b>Three Months Ended March 31, 2012:</b> |                             |            |                 |       |                            |                                     |
| Operating Revenues                        | External                    | \$ 220     | \$ 52           | \$ 48 | \$ (1)                     | \$ 319                              |
| Operating Revenues                        | Intersegment <sup>(1)</sup> | 4          | 1               |       | 4                          | (9)                                 |
| Income (Loss) Before Income Taxes         |                             | (3)        | 9               | 5     | (1)                        | 10                                  |
| Net Income (Loss)                         |                             | (1)        | 5               | 3     | (1)                        | 6                                   |
| <b>Three Months Ended March 31, 2011:</b> |                             |            |                 |       |                            |                                     |
| Operating Revenues                        | External                    | \$ 236     | \$ 59           | \$ 50 | \$                         | \$ 345                              |
| Operating Revenues                        | Intersegment <sup>(1)</sup> | 4          |                 | 1     | 7                          | (12)                                |
| Income Before Income Taxes                |                             | 7          | 10              | 6     | 2                          | (4)                                 |
| Net Income (Loss)                         |                             | 5          | 6               | 4     | (1)                        | (1)                                 |

(1) TEP includes in Operating Revenues Intersegment: 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 Dow Jones Four Corners Daily Index prices.

**NOTE 4. DEBT AND CREDIT FACILITIES**

We summarized below the significant changes to our debt from those reported in our 2011 Annual Report on Form 10-K.

**UNISOURCE ENERGY DEBT- CONVERTIBLE SENIOR NOTES**

In 2005, UniSource Energy issued \$150 million of 4.50% Convertible Senior Notes (Convertible Senior Notes) due in 2035. UniSource Energy has the option to redeem the Convertible Senior Notes, in whole or in part, for cash at par plus accrued interest. Investors may require UniSource Energy to repurchase the Convertible Senior Notes, in whole or in part, for cash at par plus accrued interest on March 1 of 2015, 2020, 2025, and 2030, and upon the occurrence of certain fundamental changes, such as a change in control. Each \$1,000 of Convertible Senior Notes can be converted into 29.001 shares of UniSource Energy Common Stock (Common Stock) at any time, which is equivalent to a conversion price of approximately \$34.48 per share of Common Stock. The conversion rate is subject to adjustments including an adjustment to reduce the conversion price upon the payment of quarterly dividends in excess of \$0.19 per share.

In December 2011 and March 2012, UniSource Energy issued two separate notices of partial redemption of the Convertible Senior Notes by calling a combined \$75 million of the \$150 million outstanding. Holders of the called Convertible Senior Notes had the option of converting their interests to Common Stock or redeeming the Convertible Senior Notes at par plus accrued interest. The notes were convertible into shares of Common Stock at a conversion rate applicable at the time of each notice. During the first three months of 2012, holders of approximately \$73 million of the Convertible Senior Notes selected for redemption converted their interests into approximately 2.1 million shares of Common Stock. The remaining \$2 million was redeemed for cash. In addition, some holders voluntarily converted their interests into approximately four thousand shares of Common Stock. As of March 31, 2012, there were approximately \$75 million of Convertible Senior Notes outstanding.

In April 2012, UniSource Energy issued a third notice of partial redemption of the Convertible Senior Notes by calling \$40 million of the \$75 million that was outstanding as of March 31, 2012. Holders of approximately \$39 million of the Convertible Senior Notes selected for redemption converted their interests into approximately 1.1 million shares of Common Stock. The remaining \$1 million was redeemed for cash. As of April 18, 2012, there were approximately \$35 million of Convertible Senior Notes outstanding.



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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**

**UNISOURCE ENERGY CREDIT AGREEMENT**

UniSource Energy had \$68 million in outstanding borrowings at March 31, 2012, and \$57 million in outstanding borrowings at December 31, 2011, under its revolving credit facility. We have included the revolver borrowings in Long-Term Debt on the balance sheet as UniSource Energy has the ability and the intent to have outstanding borrowings for the next twelve months.

**TAX-EXEMPT BONDS**

In March 2012, an industrial development authority issued \$177 million of unsecured tax-exempt pollution control bonds on behalf of TEP. The bonds bear interest at a fixed rate of 4.5%, mature in March 2030, and may be redeemed at par on or after March 1, 2022. The proceeds from the sale of the bonds together with \$8 million provided by TEP, including \$1 million for accrued interest, were deposited with a trustee to retire \$184 million of unsecured tax-exempt bonds with interest rates of 5.85% and 5.875%, and maturity dates ranging from 2026 to 2033. Since TEP's obligations on the \$184 million of debt were considered legally extinguished as of March 31, 2012, TEP retired \$184 million from its balance sheet. TEP's \$8 million payment to the trustee was the only cash flow activity since proceeds from the bonds were not received or disbursed by TEP.

TEP capitalized approximately \$2 million in costs related to the issuance of the bonds and will amortize the costs to Interest Expense Long-Term Debt through March 2030, the term of the bonds.

**TEP CREDIT AGREEMENT**

TEP had \$105 million in borrowings outstanding and \$1 million in letters of credit issued under its revolving credit facility at March 31, 2012. At December 31, 2011, TEP had \$10 million in borrowings and \$1 million outstanding in letters of credit under its revolving credit facility. TEP included the revolver borrowings in Current Liabilities on the balance sheets. The outstanding letters of credit are off-balance sheet obligations of TEP.

**UNS GAS/UNS ELECTRIC CREDIT AGREEMENT**

UNS Electric had \$4 million and \$6 million in outstanding letters of credit under the UNS Gas/UNS Electric Credit Agreement, which are not shown on the balance sheet, as of March 31, 2012 and December 31, 2011.

**COVENANT COMPLIANCE**

As of March 31, 2012, UniSource Energy and its subsidiaries were in compliance with the terms of their respective loan and credit agreements.

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited****NOTE 5. INCOME TAXES**

The differences between the income tax expense and the amount obtained by multiplying pre-tax income by the U.S. statutory federal income tax rate of 35% are as follows:

|   | UniSource<br>Energy             |             | TEP                             |             |
|---|---------------------------------|-------------|---------------------------------|-------------|
|   | Three Months Ended<br>March 31, |             | Three Months Ended<br>March 31, |             |
|   | 2012                            | 2011        | 2012                            | 2011        |
|   | -Millions of Dollars-           |             |                                 |             |
| <b>Federal Income Tax Expense/(Benefit) at Statutory Rate</b> | \$ 3                            | \$ 7        | \$ (1)                          | \$ 3        |
| State Income Tax Expense, Net of Federal Deduction            | 1                               | 1           |                                 | 1           |
| Cash Surrender Value of Life Insurance                        | (1)                             | (1)         | (1)                             | (1)         |
| <b>Total Federal and State Income Tax Expense/(Benefit)</b>   | <b>\$ 3</b>                     | <b>\$ 7</b> | <b>\$ (2)</b>                   | <b>\$ 3</b> |

The Internal Revenue Service completed its audit of the 2008 tax return in March 2012 with no change to the balance of unrecognized tax benefits.

**NOTE 6. COMMITMENTS, CONTINGENCIES, AND PROPOSED ENVIRONMENTAL MATTERS**

In addition to those reported in our 2011 Annual Report on Form 10-K, we entered into the following new long-term commitments.

**TEP COMMITMENTS**

TEP entered into new forward purchase power commitments that will settle in June 2013 through September 2013 at fixed prices per MWh. TEP's minimum payment obligation for these purchases is \$4 million.

In February 2012, TEP entered into a long-term agreement for information technology services. TEP is obligated to pay \$2 million per year over the next three years.

**UNS GAS COMMITMENTS**

UNS Gas entered into new forward fuel commitments that will settle in April 2012 through March 2015. Some of these contracts are at a fixed price per MMBtu and others are indexed to natural gas prices. Based on projected market prices as of March 31, 2012, UNS Gas' estimated minimum payment obligation for these purchases is \$2 million in each of 2012, 2013, and 2014 and \$1 million in 2015.

**UNS ELECTRIC COMMITMENTS**

UNS Electric entered into new forward purchase power commitments that will settle at fixed prices per MWh from January 2014 through December 2014. UNS Electric's minimum payment obligation for these purchases is \$8 million.

**TEP CONTINGENCIES****San Juan Mine Fire**

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In September 2011, a fire at the underground mine that provides coal to the San Juan Generating Station (San Juan) caused mining operations to shut down. The mine operator informed San Juan participants that mine operations are expected to be back in full production by the end of May 2012. TEP owns approximately 20% of San Juan, which is operated by Public Service Company of New Mexico (PNM).

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**

Based on information TEP has received to date, TEP does not expect the mine fire to have a material effect on our financial condition, results of operations, or cash flows due to the current inventory of previously mined coal and the current low market price of wholesale power. TEP expects that any incremental fuel and purchased power costs would be recoverable from customers through the PPFAC, subject to ACC approval.

**Claim Related to San Juan**

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 has 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 cannot estimate the impact of any future claims by these gas producers on the cost of coal at San Juan.

**Claims Related to Four Corners Generating Station**

In October 2011, EarthJustice, on behalf of several environmental organizations, filed a lawsuit in the United States District Court for the District of New Mexico against Arizona Public Service Company (APS) and the other Four Corners Generating Station (Four Corners) participants alleging violations of the Prevention of Significant Deterioration (PSD) provisions of the Clean Air Act at Four Corners. In January 2012, EarthJustice amended their complaint alleging violations of New Source Performance Standards resulting from equipment replacements at Four Corners. Among other things, the plaintiffs seek to have the court issue an order to cease operations at Four Corners until any required PSD permits are issued and order the payment of civil penalties, including a beneficial mitigation project.

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.

**Mine Closure Reclamation at Generating Stations Not Operated by TEP**

TEP pays ongoing reclamation costs related to coal mines that supply generating stations in which TEP has an ownership interest but does not operate. TEP is liable for a portion of final reclamation costs upon closure of the mines servicing Navajo Generating Station (Navajo), San Juan, and Four Corners. TEP's share of reclamation costs is expected to be \$27 million upon expiration of the coal supply agreements, which expire between 2016 and 2019. The reclamation liability recorded at March 31, 2012, was \$14 million and at December 31, 2011, was \$13 million.

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

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

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited****Tucson to Nogales Transmission Line**

TEP and UNS Electric are parties to a project development agreement for the joint construction of an approximately 60-mile transmission line from Tucson, Arizona to Nogales, Arizona. UNS Electric's participation in this project was initiated in response to an order by the ACC to improve the reliability of electric service in Nogales. That order was issued before UniSource Energy purchased the electric system in Nogales and surrounding Santa Cruz County in August 2003.

In 2002, the ACC authorized construction of the proposed 345-kV line along a route identified as the Western Corridor subject to a number of conditions, including the issuance of all required permits from state and federal agencies. The U.S. Forest Service subsequently expressed its preference for a different route in its final Environmental Impact Statement for the project. TEP and UNS Electric are considering options for the project. If a decision is made to pursue an alternative route, approvals will be needed from the ACC, the Department of Energy, U.S. Forest Service, Bureau of Land Management, and the International Boundary and Water Commission. As of March 31, 2012 and December 31, 2011, TEP had capitalized \$11 million related to the project, including \$2 million to secure land and land rights. If TEP does not receive the required approvals or abandons the project, TEP believes cost recovery is probable for prudent and reasonably incurred costs related to the project as a consequence of the ACC's requirement for a second transmission line serving the Nogales area.

**Resolution of Contingency**

In April 2010, the Sierra Club filed a citizens' suit under the Resource Conservation and Recovery Act (RCRA) and the Surface Mine Control and Reclamation Act (SMCRA) in the U.S. District Court for the District of New Mexico against PNM, as operator of San Juan; PNM's parent PNM Resources, Inc. (PNMR); SJCC; and SJCC's parent BHP Minerals International Inc. (BHP). The Sierra Club alleged in the suit that certain activities at San Juan and the San Juan mine associated with the treatment, storage, and disposal of coal and Coal Combustion Residuals (CCRs), primarily coal ash, are causing imminent and substantial harm to the environment, including ground and surface water in the region, and that placement of CCRs at the mine constitutes open dumping in violation of RCRA. The RCRA claims were asserted against PNM, PNMR, SJCC and BHP. The suit also included claims under SMCRA which were directed only against SJCC, and BHP. The suit sought the following relief: an injunction requiring the parties to undertake certain mitigation measures with respect to the placement of CCRs at the mine or to cease placement of CCRs at the mine; the imposition of civil penalties; and attorney's fees and costs. In March 2012, the parties entered into and filed a consent decree to settle the case. The consent decree has since been approved by the Court.

TEP owns 50% of San Juan Units 1 and 2, which represents approximately 20% of the total generation capacity at San Juan, and is responsible for its share of the settlement of the San Juan claims. TEP recorded less than \$1 million for its share of the costs to fund environmental projects and Sierra Club attorney and expert fees required by the settlement, substantially all of which was recorded in 2011. In addition, TEP is obligated to contribute up to \$1 million for its share of the construction costs for a new groundwater recovery system adjacent to San Juan and other environmental projects required by the settlement.

**PROPOSED ENVIRONMENTAL MATTERS**

TEP's generating facilities are subject to Environmental Protection Agency (EPA) limits on the amount of sulfur dioxide (SO<sub>2</sub>), nitrogen oxide (NO<sub>x</sub>) and other emissions released into the atmosphere. TEP may incur additional costs to comply with future changes in federal and state environmental laws and regulations and permit requirements at its electric generating facilities. Compliance with these changes may reduce operating efficiency.

**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 December 2011, the EPA issued the final rules establishing the standards for the control of emissions of mercury and other hazardous air pollutants from electric generating units.



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### **NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**

#### Navajo

Based on the EPA's final standards, mercury and particulate emission control equipment may be required at Navajo by 2015. TEP's share of the estimated capital cost of this equipment is less than \$1 million for mercury control and approximately \$43 million if the installation of baghouses to control particulates is necessary. TEP expects its share of the annual operating costs for mercury control and baghouses to be less than \$1 million each.

#### Springerville Generating Station

Based on the EPA's final standards, mercury emission control equipment may be required at Springerville Generating Station (Springerville) by 2015. The estimated capital cost of this equipment for Springerville Units 1 and 2 is approximately \$5 million. The annual operating cost associated with the mercury emission control equipment is expected to be approximately \$3 million.

#### San Juan

Current emission controls at San Juan are expected to be adequate to achieve compliance with the EPA's final standards.

#### Sundt Generating Station

TEP does not anticipate that the final EPA rule will have a material capital impact on Sundt Generating Station.

#### Four Corners

Based on the EPA's final standards, mercury emission control equipment may be required at Four Corners by 2015. The estimated capital cost of this equipment is less than \$1 million. The annual operating cost associated with the mercury emission control equipment is expected to be less than \$1 million.

### **Regional Haze Rules**

The EPA's regional haze rules require emission controls known as Best Available Retrofit Technology (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 and to submit a state implementation plan to the EPA for approval. Navajo and Four Corners are located on the Navajo Indian Reservation and therefore are not subject to state regulatory jurisdictions. The EPA oversees regional haze planning for these facilities.

Compliance with the EPA's BART determinations, coupled with the financial impact of future climate change legislation, other environmental regulations and other business considerations could jeopardize the economic viability of the Navajo, San Juan, and Four Corners facilities or the ability of individual participants to meet their obligations and maintain participation in these facilities. TEP cannot predict the ultimate outcome of these matters.

#### Navajo

The EPA is expected to issue a proposed rule establishing the BART for Navajo following the consideration of a report by the National Renewable Energy Laboratory in partnership with the Department of the Interior and the Department of Energy. The report addresses potential energy, environmental, and economic issues related to compliance with the regional haze rule. The report was submitted to the EPA in January 2012. If the EPA determines that Selective Catalytic Reduction (SCR) technology is required at Navajo, the capital cost impact to TEP is estimated to be \$42 million. In addition, the installation of SCR at Navajo could increase the generating facility's particulate emissions necessitating the installation of baghouses. If baghouses are required, TEP's estimated share of the capital expenditure for the required baghouses would be approximately \$43 million. The cost of required pollution controls will not be known until final determinations are made by the regulatory agencies. TEP anticipates that if the EPA finalizes a BART rule for Navajo that requires SCR, the owners would have five years to achieve compliance.



**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited****San Juan**

In August 2011, the EPA issued a Federal Implementation Plan (FIP) establishing new emission limits for air pollutants at San Juan. The FIP requires the installation of SCR technology with sorbent injection on all four units within five years to reduce NOx and control sulfuric acid emissions. Based on two cost analyses commissioned by PNM, TEP's share of the cost to install SCR with sorbent injection is estimated to be between \$180 million and \$200 million.

In 2011, PNM filed a petition for review of, and a motion to stay, the FIP with the Tenth Circuit U. S. Court of Appeals (Circuit Court). In addition, PNM filed a request for reconsideration of the rule with the EPA and a request to stay the effectiveness of the rule pending the EPA's reconsideration, and the review by the Circuit Court. The State of New Mexico filed similar motions with the Circuit Court and the EPA. In March 2012, the Circuit Court denied the motion for stay.

Several environmental groups were granted permission to join in opposition to PNM's petition to review in the Circuit Court. In addition, WildEarth Guardians filed a separate appeal against the EPA challenging the five-year, rather than three-year, implementation schedule. PNM was granted permission to join in opposition to that appeal.

**Four Corners**

In February 2011, the EPA supplemented the proposed FIP for the BART determination at Four Corners that would require the installation of SCR on Units 4 and 5 by 2018. TEP's estimated share of the capital costs to install SCR is approximately \$35 million.

**NOTE 7. EMPLOYEE BENEFIT PLANS**

The components of UniSource Energy's net periodic benefit plan cost are as follows:

|   | Pension Benefits                |             | Other Postretirement Benefits   |             |
|---|---------------------------------|-------------|---------------------------------|-------------|
|   | Three Months Ended<br>March 31, |             | Three Months Ended<br>March 31, |             |
|   | 2012                            | 2011        | 2012                            | 2011        |
|   | -Millions of Dollars-           |             |                                 |             |
| <b>Components of Net Periodic Benefit Plan Cost</b> |                                 |             |                                 |             |
| Service Cost  | \$ 2                            | \$ 2        | \$                              | \$          |
| Interest Cost                                       | 4                               | 4           | 1                               | 1           |
| Expected Return on Plan Assets                      | (4)                             | (4)         |                                 |             |
| Amortization of Net Loss                            | 2                               | 2           |                                 |             |
| <b>Net Periodic Benefit Plan Cost</b>               | <b>\$ 4</b>                     | <b>\$ 4</b> | <b>\$ 1</b>                     | <b>\$ 1</b> |

The table above includes pension benefit plan costs of \$1 million and other postretirement benefit plan costs of less than \$0.1 million for UNS Gas and UNS Electric.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**

**NOTE 8. SHARE-BASED COMPENSATION PLANS**

**PERFORMANCE SHARES**

In March 2012, the UniSource Energy Compensation Committee granted 80,140 performance share awards to upper management. Half of the performance share awards had a grant date fair value, based on a Monte Carlo simulation, of \$32.71 per share. Those awards will be paid out in Common Stock based on a comparison of UniSource Energy's cumulative Total Shareholder Return to the Edison Electric Institute Index during the performance period of January 1, 2012 through December 31, 2014. The remaining half had a grant date fair value of \$36.40 per share and will be paid out in Common Stock based on cumulative net income for the three-year period ended December 31, 2014. 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 are eligible for dividend equivalents during the performance period.

**SHARE-BASED COMPENSATION EXPENSE**

UniSource Energy and TEP recorded less than \$1 million of share-based compensation expense for each of the three months ended March 31, 2012 and March 31, 2011.

At March 31, 2012, 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 December 2014. At March 31, 2012, one million shares were awarded but not yet issued, including target performance based shares, under the share-based compensation plans.

**NOTE 9. FAIR VALUE MEASUREMENTS**

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

|  | UniSource Energy   |   |  |           |
|--|--|---|--|-----------|
|  | Quoted Prices<br>In<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total     |
|  | March 31, 2012   |   |  |           |
|  | -Millions of Dollars-  |   |  |           |
| <b>Assets</b>  |  |   |  |           |
| Cash Equivalents <sup>(1)</sup>  | \$ 22  | \$  | \$   | \$ 22     |
| Rabbi Trust Investments to Support the Deferred Compensation and Supplemental Executive Retirement Plans (SERP) <sup>(2)</sup> |  | 18  |  | 18        |
| Energy Contracts <sup>(3)</sup>  |  | 1   | 14   | 15        |
| <b>Total Assets</b>  | <b>22</b>  | <b>19</b>   | <b>14</b>  | <b>55</b> |

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**Liabilities**

|                                    |      |      |      |
|------------------------------------|------|------|------|
| Energy Contracts <sup>(3)</sup>    | (28) | (27) | (55) |
| Interest Rate Swaps <sup>(4)</sup> | (11) |      | (11) |

|                          |             |             |             |
|--------------------------|-------------|-------------|-------------|
| <b>Total Liabilities</b> | <b>(39)</b> | <b>(27)</b> | <b>(66)</b> |
|--------------------------|-------------|-------------|-------------|

|   |       |         |         |         |
|---|-------|---------|---------|---------|
| <b>Net Total Assets and (Liabilities)</b> | \$ 22 | \$ (20) | \$ (13) | \$ (11) |
|---|-------|---------|---------|---------|

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## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited

|  | UniSource Energy   |   |  | Total  |
|--|--|---|--|--------|
|  | Quoted Prices<br>In<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |        |
|  |  |   |  |        |
| -Millions of Dollars-  |  |   |  |        |
| <b>Assets</b>  |  |   |  |        |
| Cash Equivalents <sup>(1)</sup>  | \$ 23  | \$  | \$   | \$ 23  |
| Rabbi Trust Investments to Support the Deferred Compensation and SERP <sup>(2)</sup> |  | 16  |  | 16     |
| Energy Contracts <sup>(3)</sup>  |  |   | 14   | 14     |
| <b>Total Assets</b>  | 23   | 16  | 14   | 53     |
| <b>Liabilities</b>   |  |   |  |        |
| Energy Contracts <sup>(3)</sup>  |  | (21)  | (24)   | (45)   |
| Interest Rate Swaps <sup>(4)</sup>   |  | (12)  |  | (12)   |
| <b>Total Liabilities</b>   |  | (33)  | (24)   | (57)   |
| <b>Net Total Assets and (Liabilities)</b>  | \$ 23  | \$ (17)   | \$ (10)  | \$ (4) |

|  | TEP  |   |  | Total |
|--|--|---|--|-------|
|  | Quoted Prices<br>In<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |       |
|  |  |   |  |       |
| -Millions of Dollars-  |  |   |  |       |
| <b>Assets</b>  |  |   |  |       |
| Cash Equivalents <sup>(1)</sup>  | \$ 8   | \$  | \$   | \$ 8  |
| Rabbi Trust Investments to Support the Deferred Compensation and SERP <sup>(2)</sup> |  | 18  |  | 18    |
| Energy Contracts <sup>(3)</sup>  |  |   | 3  | 3     |
| <b>Total Assets</b>  | 8  | 18  | 3  | 29    |
| <b>Liabilities</b>   |  |   |  |       |

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|   |             |            |             |
|---|-------------|------------|-------------|
| Energy Contracts <sup>(3)</sup>           | (15)        | (3)        | (18)        |
| Interest Rate Swaps <sup>(4)</sup>        | (11)        |            | (11)        |
| <b>Total Liabilities</b>                  | <b>(26)</b> | <b>(3)</b> | <b>(29)</b> |
| <b>Net Total Assets and (Liabilities)</b> | \$ 8        | \$ (8)     | \$          |

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**

|  | TEP  |   |  | Total       |
|--|--|---|--|-------------|
|  | Quoted Prices<br>In<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |             |
|  | December 31, 2011  |   |  |             |
|  | -Millions of Dollars-  |   |  |             |
| <b>Assets</b>  |  |   |  |             |
| Cash Equivalents <sup>(1)</sup>  | \$ 8   | \$  | \$   | \$ 8        |
| Rabbi Trust Investments to Support the Deferred Compensation and SERP <sup>(2)</sup> |  | 16  |  | 16          |
| Energy Contracts <sup>(3)</sup>  |  |   | 3  | 3           |
| <b>Total Assets</b>  | <b>8</b>   | <b>16</b>   | <b>3</b>   | <b>27</b>   |
| <b>Liabilities</b>   |  |   |  |             |
| Energy Contracts <sup>(3)</sup>  |  | (9)   | (3)  | (12)        |
| Interest Rate Swaps <sup>(4)</sup>   |  | (11)  |  | (11)        |
| <b>Total Liabilities</b>   |  | <b>(20)</b>   | <b>(3)</b>   | <b>(23)</b> |
| <b>Net Total Assets and (Liabilities)</b>  | <b>\$ 8</b>  | <b>\$ (4)</b>   | <b>\$</b>  | <b>\$ 4</b> |

- (1) Cash Equivalents are based on observable market prices and include the fair value of money market funds and certificates of deposit. These amounts are included in Cash and Cash Equivalents and Investments and Other Property - Other on the balance sheets.
- (2) Rabbi Trust Investments include amounts held in mutual and money market funds related to deferred compensation and SERP benefits. The valuation is based on quoted prices traded in active markets. These investments are included in Investments and Other Property - Other on the balance sheets.
- (3) Energy Contracts include gas swap agreements (Level 2), gas and power options (Level 3), forward power purchase and sales contracts (Level 3), and forward power purchase contracts indexed to gas (Level 3), entered into to reduce exposure to energy price risk. These contracts are included in Derivative Instruments and Other on the balance sheets. The valuation techniques are described below. See Note 12.
- (4) Interest Rate Swaps are valued based on the 3-month or 6-month London Interbank Offered Rate (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.

**ENERGY CONTRACTS**

We primarily apply the market approach for recurring fair value measurements. When we have observable inputs for substantially the full term of the asset or liability - such as gas swap derivatives valued using New York Mercantile Exchange pricing, adjusted for basis differences - we categorize the instrument in Level 2. We categorize derivatives in Level 3 when we use 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, and industry publications and rely on our own price experience from active transactions in the market. We primarily use one set of quotations each for power and for gas and then validate those prices using other sources. We believe that the market information provided is reflective of market conditions as of the time and date



indicated.

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

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

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

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**

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

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

|                  | Fair Value at<br>March 31,<br>2012<br>-Millions of Dollars- | Valuation<br>Technique | Unobservable<br>Input | Range of<br>Unobservable<br>Input |
|------------------|---|------------------------|-----------------------|-----------------------------------|
| Energy Contracts |   | Market approach        | Historical price      | +/- 5%                            |
|                  | \$ (13)   | and option models      | curve relationships   |                                   |
|                  |   |                        | Adjustments for       | +/- 5%                            |
|                  |   |                        | non-standard          |                                   |
|                  |   |                        | delivery points       |                                   |
|                  |   |                        | Correlation factors   | +/- 5%                            |

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, or as a component of other comprehensive income rather than in the income statement. A 5% increase or decrease in all the unobservable inputs collectively would result in a change in the fair value of energy contracts of \$1 million. TEP had no exposure to Level 3 energy contracts with unobservable inputs.

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<br>March 31, 2012    |                         |
|---|---|-------------------------|
|   | UniSource Energy<br>Energy<br>Contracts | TEP<br>Energy Contracts |
|   | -Millions of Dollars-                   |                         |
| <b>Balance as of December 31, 2011</b>  | \$ (10)                                 | \$                      |
| Realized/Unrealized Gains/(Losses) Recorded to:   |   |                         |
| Net Regulatory Assets/(Liabilities) Derivative Instruments  | (5)                                     | 1                       |
| Other Comprehensive Loss  | (1)                                     | (1)                     |
| Settlements   | 3                                       |                         |
| <b>Balance as of March 31, 2012</b>   | \$ (13)                                 | \$                      |
| Total (Losses) Attributable to the Change in Unrealized Gains/(Losses) Relating to Assets/(Liabilities) Still Held at the End of the Period | \$ (2)                                  | \$                      |



**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**

|   | <b>Three Months Ended<br/>March 31, 2011</b>     |                                 |
|---|--|---------------------------------|
|   | <b>UniSource Energy<br/>Energy<br/>Contracts</b> | <b>TEP<br/>Energy Contracts</b> |
|   | -Millions of Dollars-                            |                                 |
| <b>Balance as of December 31, 2010</b>  | \$ (10)  | \$ 1                            |
| Realized/Unrealized Gains/(Losses) Recorded to:   |  |                                 |
| Net Regulatory Assets/(Liabilities) Derivative Instruments  | (3)  | 1                               |
| Settlements   | 2  | (1)                             |
| <b>Balance as of March 31, 2011</b>   | \$ (11)  | \$ 1                            |
| Total Gains/(Losses) Attributable to the Change in Unrealized Gains/(Losses) Relating to Assets/(Liabilities) Still Held at the End of the Period | \$ (3)   | \$ 1                            |

**FINANCIAL INSTRUMENTS NOT CARRIED AT FAIR VALUE**

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

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

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

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

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

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**

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

|                                | Fair Value Hierarchy | March 31, 2012 |            | December 31, 2011 |            |
|--------------------------------|----------------------|----------------|------------|-------------------|------------|
|                                |                      | Carrying Value | Fair Value | Carrying Value    | Fair Value |
| -Millions of Dollars-          |                      |                |            |                   |            |
| <b>Assets:</b>                 |                      |                |            |                   |            |
| TEP Investment in Lease Debt   | Level 2              | \$ 10          | \$ 10      | \$ 29             | \$ 29      |
| TEP Investment in Lease Equity | Level 3              | 36             | 23         | 37                | 21         |
| <b>Liabilities:</b>            |                      |                |            |                   |            |
| Long-Term Debt                 |                      |                |            |                   |            |
| UniSource Energy               | Level 2              | 1,447          | 1,476      | 1,517             | 1,543      |
| TEP                            | Level 2              | 1,074          | 1,072      | 1,080             | 1,061      |

TEP intends to hold the \$10 million investment in Springerville Lease Debt to maturity. This investment is stated at amortized cost, which means the purchase cost has been adjusted for the amortization of the premium and discount to maturity.

**NOTE 10. UNISOURCE 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. Except when the effect would be anti-dilutive, the diluted EPS calculation includes the impact of shares that could be issued upon exercise of outstanding stock options; contingently issuable shares under equity-based awards or common shares that would result from the conversion of Convertible Senior Notes. 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 notes were converted to Common Stock.

The following table shows the effects of potentially dilutive Common Stock on the weighted average number of shares:

|   | Three Months Ended |           |
|---|--------------------|-----------|
|   | March 31, 2012     | 2011      |
| -Thousands of Dollars-  |                    |           |
| <b>Numerator:</b>   |                    |           |
| Net Income  | \$ 6,476           | \$ 13,472 |
| Income from Assumed Conversion of Convertible Senior Notes  |                    | 1,097     |
| <b>Adjusted Numerator</b>   | \$ 6,476           | \$ 14,569 |
| -Thousands of Shares-   |                    |           |
| <b>Denominator:</b>   |                    |           |
| Weighted Average Shares of Common Stock Outstanding:  |                    |           |
| Common Shares Issued  | 37,893             | 36,596    |
| Fully Vested Deferred Stock Units   | 138                | 117       |
| Participating Securities  |                    | 76        |
| <b>Total Weighted Average Shares of Common Stock Outstanding and Participating Securities Basic</b> | 38,031             | 36,789    |

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|   |                |        |        |
|---|----------------|--------|--------|
| Effect of Dilutive Securities:                                  |                |        |        |
| Convertible Senior Notes  |                |        | 4,241  |
| Options and Stock Issuable under Share-Based Compensation Plans | 290            |        | 371    |
| <b>Total Shares</b>   | <b>Diluted</b> | 38,321 | 41,401 |

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**

Stock options to purchase 101,000 shares of Common Stock were outstanding during the three months ended March 31, 2012, but were not included in the computation of diluted EPS because the stock options' exercise prices were greater than the average market price of the Common Stock. Similarly, for the three months ended March 31, 2011, 168,000 of stock options were not included in the diluted EPS computation.

For the three months ended March 31, 2012, 2.2 million potentially dilutive shares from the conversion of Convertible Senior Notes, and after-tax interest expense of \$0.9 million, were not included in the computation of diluted EPS because to do so would be anti-dilutive. In April 2012, holders of approximately \$39 million of Convertible Senior Notes converted their interests into approximately 1.1 million shares of Common Stock. This conversion of Convertible Senior Notes to Common Stock had minimal impact on diluted EPS.

**NOTE 11. SUPPLEMENTAL CASH FLOW INFORMATION**

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

|  | <b>UniSource Energy</b>   |                  |
|--|---------------------------|------------------|
|  | <b>Three Months Ended</b> |                  |
|  | <b>March 31,</b>          |                  |
|  | <b>2012</b>               | <b>2011</b>      |
|  | -Thousands of Dollars-    |                  |
| <b>Net Income</b>  | \$ 6,476                  | \$ 13,472        |
| <b>Adjustments to Reconcile Net Income</b>                               |                           |                  |
| <b>To Net Cash Flows from Operating Activities</b>                       |                           |                  |
| Depreciation Expense   | 34,984                    | 32,790           |
| Amortization Expense   | 8,664                     | 7,377            |
| Depreciation and Amortization Recorded to Fuel and Other O&M             | 1,644                     | 1,418            |
| Amortization of Deferred Debt-Related Costs Included in Interest Expense | 808                       | 1,045            |
| Provision for Retail Customer Bad Debts                                  | 706                       | 806              |
| Use of Renewable Energy Credits for Compliance                           | 1,414                     | 2,535            |
| Deferred Income Taxes  | 916                       | 14,675           |
| Pension and Postretirement Expense                                       | 5,463                     | 5,306            |
| Pension and Postretirement Funding                                       | (2,541)                   | (1,969)          |
| Share-Based Compensation Expense   | 494                       | 926              |
| Allowance for Equity Funds Used During Construction                      | (850)                     | (1,416)          |
| CTC Revenue Refunded   |                           | (1,847)          |
| Decrease to Reflect PPFAC/PGA Recovery                                   | (2,561)                   | (5,388)          |
| Changes in Assets and Liabilities which Provided (Used)                  |                           |                  |
| Cash Exclusive of Changes Shown Separately                               |                           |                  |
| Accounts Receivable  | 27,294                    | 23,372           |
| Materials and Fuel Inventory   | (12,720)                  | 5,913            |
| Accounts Payable   | (24,591)                  | (4,894)          |
| Income Taxes   | (73)                      | (7,915)          |
| Interest Accrued   | (13,191)                  | (16,842)         |
| Taxes Other Than Income Taxes  | 10,009                    | 10,170           |
| Other  | 4,225                     | (2,695)          |
| <b>Net Cash Flows - Operating Activities</b>                             | <b>\$ 46,570</b>          | <b>\$ 76,839</b> |

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**

|  | TEP                    |                  |
|--|------------------------|------------------|
|  | Three Months Ended     |                  |
|  | March 31,              |                  |
|  | 2012                   | 2011             |
|  | -Thousands of Dollars- |                  |
| <b>Net Income (Loss)</b>   | \$ (1,461)             | \$ 4,704         |
| <b>Adjustments to Reconcile Net Income (Loss)</b>                        |                        |                  |
| <b>To Net Cash Flows from Operating Activities</b>                       |                        |                  |
| Depreciation Expense   | 27,467                 | 25,733           |
| Amortization Expense   | 9,591                  | 8,304            |
| Depreciation and Amortization Recorded to Fuel and Other O&M             | 1,248                  | 1,032            |
| Amortization of Deferred Debt-Related Costs Included in Interest Expense | 525                    | 654              |
| Provision for Retail Customer Bad Debts                                  | 434                    | 479              |
| Use of Renewable Energy Credits for Compliance                           | 1,217                  | 2,391            |
| Deferred Income Taxes  | (1,600)                | 9,631            |
| Pension and Postretirement Expense                                       | 4,821                  | 4,707            |
| Pension and Postretirement Funding                                       | (2,185)                | (1,595)          |
| Share-Based Compensation Expense   | 390                    | 722              |
| Allowance for Equity Funds Used During Construction                      | (675)                  | (1,219)          |
| CTC Revenue Refunded   |                        | (1,847)          |
| Decrease to Reflect PPFAC Recovery                                       | (7,686)                | (8,937)          |
| <b>Changes in Assets and Liabilities which Provided (Used)</b>           |                        |                  |
| Cash Exclusive of Changes Shown Separately                               |                        |                  |
| Accounts Receivable  | 17,956                 | 17,591           |
| Materials and Fuel Inventory   | (12,660)               | 6,301            |
| Accounts Payable   | (17,668)               | (24)             |
| Income Taxes   | (618)                  | (8,005)          |
| Interest Accrued   | (8,004)                | (11,965)         |
| Taxes Other Than Income Taxes  | 7,985                  | 8,327            |
| Other  | 2,474                  | (3,821)          |
| <b>Net Cash Flows Operating Activities</b>                               | <b>\$ 21,551</b>       | <b>\$ 53,163</b> |

**Non-Cash Transactions**

In the first quarter of 2012, UniSource Energy partially redeemed Convertible Senior Notes, resulting in non-cash transactions for the issuance of Common Stock. See Note 4.

In March 2012, TEP's redemption of \$184 million of tax-exempt bonds resulted in a non-cash transaction. See Note 4.

**NOTE 12. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES****RISKS AND OVERVIEW**

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





**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**

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

**DERIVATIVES POLICY**

There have been no significant changes to our derivative instrument or credit risk policies as described in our Annual Report on Form 10-K for the year ended December 31, 2011.

**FINANCIAL IMPACT OF DERIVATIVES****Cash Flow Hedges**

At March 31, 2012 and December 31, 2011, UniSource Energy and TEP had liabilities related to cash flow hedges of \$14 million.

The after-tax unrealized gains (losses) on derivative activities and amounts reclassified to earnings are reported in the statements of other comprehensive income (loss).

**Regulatory Treatment of Commodity Derivatives**

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

|  | UniSource Energy             |        | TEP  |        |
|--|------------------------------|--------|------|--------|
|  | Three Months Ended March 31, |        |      |        |
|  | 2012                         | 2011   | 2012 | 2011   |
|  | -Millions of Dollars-        |        |      |        |
| Increase (Decrease) to Regulatory Assets | \$ 8                         | \$ (6) | \$ 5 | \$ (2) |

The fair value of derivative assets and liabilities were as follows:

|                 | UniSource Energy      |              | TEP       |              |
|-----------------|-----------------------|--------------|-----------|--------------|
|                 | March 31,             | December 31, | March 31, | December 31, |
|                 | 2012                  | 2011         | 2012      | 2011         |
|                 | -Millions of Dollars- |              |           |              |
| Assets          | \$ 15                 | \$ 14        | \$ 4      | \$ 3         |
| Liabilities     | (52)                  | (43)         | (15)      | (9)          |
| Net Liabilities | \$ (37)               | \$ (29)      | \$ (11)   | \$ (6)       |

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

UniSource Energy                      TEP

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|                                      | Three Months Ended March 31, |      |      |      |
|--------------------------------------|------------------------------|------|------|------|
|                                      | 2012                         | 2011 | 2012 | 2011 |
|                                      | -Millions of Dollars-        |      |      |      |
| Realized Losses on Settled Gas Swaps | \$ 7                         | \$ 6 | \$ 2 | \$ 1 |

At March 31, 2012, UniSource Energy and TEP had contracts that will settle through the third quarter of 2015.

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited****Other Commodity Derivatives**

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

|  | <b>Three Months Ended</b> |             |
|--|---------------------------|-------------|
|  | <b>March 31,</b>          |             |
|  | <b>2012</b>               | <b>2011</b> |
|  | -Millions of Dollars-     |             |
| Recorded in Wholesale Sales:                                     |                           |             |
| Forward Power Sales  | \$ (1)                    | \$ (1)      |
| Forward Power Purchases  | 2                         | 1           |
| <br>Total Sales and Purchases Not Resulting in Physical Delivery | <br>\$ 1                  | <br>\$      |

**DERIVATIVE VOLUMES**

At March 31, 2012, UniSource Energy had gas swaps totaling 25,038 Billion British thermal units (GBtu) and power contracts totaling 2,968 Gigawatt-hours (GWh); while TEP had gas swaps totaling 17,182 GBtu and power contracts totaling 877 GWh. At December 31, 2011, UniSource Energy had gas swaps totaling 14,856 GBtu and power contracts totaling 3,147 GWh, while TEP had gas swaps totaling 6,855 GBtu and power contracts totaling 815 GWh. We account for gas swaps and power contracts as derivatives.

**CREDIT RISK ADJUSTMENT**

When the fair value of our derivative contracts is reflected as an asset, the counterparty owes us and this creates credit risk. We also consider the impact of our own credit risk on instruments that are in a net liability position. The impact of counterparty credit risk and our own credit risk on the fair value of derivative asset contracts was less than \$0.5 million at March 31, 2012 and at December 31, 2011.

**CONCENTRATION OF CREDIT RISK**

The following table shows the sum of the fair value of all derivative instruments under contracts with credit risk-related contingent features that are in a net liability position at March 31, 2012. Since credit risk-related contingent features were not triggered in the periods presented, UniSource Energy and TEP have not posted cash collateral.

|  | <b>UniSource Energy</b> | <b>TEP</b> |
|--|-------------------------|------------|
|  | <b>March 31, 2012</b>   |            |
|  | -Millions of Dollars-   |            |
| Net Liability Position   | \$ 68                   | \$ 24      |
| Letters of Credit  | 4                       | 1          |
| Additional Collateral to Post if Contingent Features Triggered | 67                      | 24         |

As of March 31, 2012, TEP had \$16 million of credit exposure to other counterparties creditworthiness related to its wholesale marketing and gas hedging activities, of which three counterparties individually composed greater than 10% of the total credit exposure. UNS Electric had less than \$1 million of such credit exposure related to its supply and hedging contracts, concentrated primarily with one counterparty. At March 31, 2012, UNS Gas had no exposure to other counterparties creditworthiness.



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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Concluded) Unaudited**

**NOTE 13. REVIEW BY INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The UniSource Energy and TEP condensed consolidated financial statements as of March 31, 2012, and for the three months ended March 31, 2012 and 2011, have been reviewed by PricewaterhouseCoopers LLP, an independent registered public accounting firm. Their reports (dated April 30, 2012) are included on pages 1 and 2. The reports of PricewaterhouseCoopers LLP state that they did not audit and they do not express an opinion on that unaudited financial information. Accordingly, the degree of reliance on their reports on such information should be restricted in light of the limited nature of the review procedures applied. PricewaterhouseCoopers LLP is not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their reports on the unaudited financial information because neither of those reports is a report or a part of the registration statements prepared or certified by PricewaterhouseCoopers LLP within the meaning of Sections 7 and 11 of the Securities Act of 1933.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Management's Discussion and Analysis explains the results of operations, the general financial condition, and the outlook for UniSource Energy Corporation (UniSource Energy) and its three primary business segments. It includes the following:

outlook and strategies;

operating results during the first quarter of 2012 compared with the same period in 2011;

factors affecting our results and outlook;

liquidity, capital needs, capital resources, and contractual obligations;

dividends; and

critical accounting estimates.

Management's Discussion and Analysis should be read in conjunction with (i) UniSource Energy's and Tucson Electric Power Company's (TEP) 2011 Annual Report on Form 10-K and (ii) the Condensed Consolidated Financial Statements that begin on page three of this document. The Condensed Consolidated Financial Statements present the results of operations for the three months ended March 31, 2012 and 2011. Management's Discussion and Analysis explains the differences between periods for specific line items of the Condensed Consolidated Financial Statements.

**UNISOURCE ENERGY CONSOLIDATED**

**OVERVIEW OF CONSOLIDATED BUSINESS**

UniSource Energy is a utility services holding company engaged, through its subsidiaries, in the electric generation and energy delivery business. Each of UniSource Energy's subsidiaries is a separate legal entity with its own assets and liabilities. UniSource Energy owns 100% of TEP, UniSource Energy Services, Inc. (UES), Millennium Energy Holdings, Inc. (Millennium), and UniSource Energy Development Company (UED).

TEP is a regulated public utility and UniSource Energy's largest operating subsidiary, representing approximately 82% of UniSource Energy's total assets as of March 31, 2012. TEP generates, transmits, and distributes electricity to approximately 405,000 retail electric customers in a 1,155 square mile area in southeastern Arizona. TEP also sells electricity to other utilities and power marketing entities, located primarily in the western U.S. In addition, TEP operates Springerville Unit 3 on behalf of Tri-State Generation and Transmission Association, Inc. (Tri-State) and Springerville Unit 4 on behalf of Salt River Project Agricultural Improvement and Power District (SRP).

UES holds the common stock of two regulated public utilities, UNS Gas, Inc. (UNS Gas) and UNS Electric, Inc. (UNS Electric). UNS Gas is a regulated gas distribution company, which services approximately 148,000 retail customers in Mohave, Yavapai, Coconino, and Navajo counties in northern Arizona, as well as in Santa Cruz County in southern Arizona. UNS Electric is a regulated public utility, which generates, transmits, and distributes electricity to approximately 92,000 retail customers in Mohave and Santa Cruz counties. In July 2011, UNS Electric purchased Black Mountain Generating Station (BMGS) from UED. This transaction did not impact UniSource Energy's consolidated financial statements.

UED currently has no significant remaining assets.

Millennium's investments in unregulated businesses represent less than 1% of UniSource Energy's assets as of March 31, 2012.

References to we and our are to UniSource Energy and its subsidiaries, collectively.



**Table of Contents****OUTLOOK AND STRATEGIES**

Our financial prospects and outlook are affected by many factors including: the 2008 TEP Rate Order that freezes Base Rates through 2012; national and regional economic conditions; volatility in the financial markets; environmental laws and regulations; and other regulatory factors. Our plans and strategies include the following:

Focusing on our core utility businesses through operational excellence, investing in utility rate base, emphasizing customer satisfaction, maintaining a strong community presence, and achieving constructive regulatory outcomes.

Developing strategic responses to new environmental regulations and potential new legislation, including potential limits on greenhouse gas (GHG) emissions. We are evaluating TEP's existing mix of generation resources and defining steps to achieve environmental objectives that provide an appropriate return on investment and are consistent with earnings growth.

Expanding TEP's and UNS Electric's portfolio of renewable energy resources and programs to meet Arizona's Renewable Energy Standard (RES) while creating ownership opportunities for renewable energy projects that benefit customers, shareholders, and the communities we serve.

Developing strategic responses to Arizona's Energy Efficiency Standards that protect the financial stability of our utility businesses and provide benefits to our customers.

**RESULTS OF OPERATIONS****Contribution by Business Segment**

The table below shows the contributions to our consolidated after-tax earnings by business segment:

| <b>Three Months Ended March 31,</b>                          | 2012                  | 2011         |
|--|-----------------------|--------------|
|  | -Millions of Dollars- |              |
| <b>TEP</b>   | \$ (1)                | \$ 5         |
| UNS Gas  | 5                     | 6            |
| UNS Electric   | 3                     | 4            |
| Other Non-Reportable Segments and Adjustments <sup>(1)</sup> | (1)                   | (2)          |
| <b>Consolidated Net Income</b>                               | <b>\$ 6</b>           | <b>\$ 13</b> |

<sup>(1)</sup> Includes: UniSource Energy parent company expenses; Millennium; UED; and intercompany eliminations.

**Revision of Prior Period Financial Statements**

In 2011, we identified errors related to amounts recorded as owed to or payable by TEP for electricity deliveries settled in-kind or to be settled in-kind during prior years under our transmission, interconnection, and certain joint operating agreements. Separately, in 2011, we identified errors in the calculation of income tax expense, in prior years, arising from not treating a portion of the Allowance for Funds Used During Construction, as a permanent book to tax difference.

We assessed the materiality of these errors on prior period financial statements and concluded they were not material to any prior annual or interim periods, but the cumulative impact, if recognized in 2011, would have been material to the results in 2011. As a result, in accordance with Staff Accounting Bulletin 108, we revised our prior period financial statements to correct these errors. See Note 1.



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### **Executive Overview**

#### **First Quarter of 2012 Compared with the First Quarter of 2011**

##### *TEP*

TEP reported a net loss of \$1 million in the first quarter of 2012 compared with net income of \$5 million in the first quarter of 2011. The net loss in the first quarter of 2012 is attributable to: a \$3 million decrease in retail margin revenues; a \$5 million decrease in long-term wholesale margin revenues; a \$3 million increase in depreciation and amortization expense; and a \$1 million increase in interest expense. These items were partially offset by a \$2 million decrease in Base operations and maintenance (O&M) expense. See *Tucson Electric Power Company, Results of Operations*, below for more information.

##### *UNS Gas and UNS Electric*

UNS Gas reported net income of \$5 million in the first quarter of 2012 compared with net income of \$6 million in the same period of 2011. See *UNS Gas, Results of Operations*, below for more information.

UNS Electric reported net income of \$3 million in the first quarter of 2012 compared with net income of \$4 million in the first quarter of 2011. See *UNS Electric, Results of Operations*, below for more information.

##### *Other Non-Reportable Segments*

The results reported for Other Non-Reportable Segments include UniSource Energy parent company expenses, Millennium, UED, and intercompany eliminations. See *Other Non-Reportable Segments, Results of Operations*, below, for more information.

#### **O&M Expense**

The table below summarizes the items included in UniSource Energy's Other Operations and Maintenance (O&M) expense:

| <b>Three Months Ended March 31,</b>  | <b>2012</b>           | <b>2011</b> |
|--|-----------------------|-------------|
|  | -Millions of Dollars- |             |
| UniSource Energy Base O&M (Non-GAAP) <sup>(1)</sup>  | \$ 69                 | \$ 71       |
| Reimbursed Expenses Related to Springerville Units 3 and 4                                     | 13                    | 16          |
| Expenses Related to Customer-Funded Renewable Energy and Demand Side Management (DSM) Programs | 12                    | 14          |
| Total UniSource Energy Other O&M (GAAP)  | \$ 94                 | \$ 101      |

<sup>(1)</sup> Base O&M, a non-GAAP financial measure, should not be considered as an alternative to Other O&M, which is determined in accordance with GAAP. We believe Base O&M provides useful information to investors because it represents the fundamental level of operating and maintenance expense related to our core business. Base O&M excludes expenses that are directly offset by revenues collected from customers and other third parties.

### **LIQUIDITY AND CAPITAL RESOURCES**

#### **Liquidity**

Dividends from UniSource Energy's subsidiaries represent the parent company's main source of liquidity. Under UniSource Energy's tax sharing agreement, subsidiaries make income tax payments to UniSource Energy, which makes payments on behalf of the consolidated group to taxing authorities. The table below provides a summary of the liquidity position of UniSource Energy and each of its segments.



**Table of Contents**

| Balances as of April 18, 2012 | Cash and<br>Cash<br>Equivalents | Borrowings under<br>Revolving<br>Credit<br>Facility <sup>(1)</sup> | Amount Available<br>under<br>Revolving<br>Credit<br>Facility |
|-------------------------------|---------------------------------|--|--|
|                               |                                 | -Millions of Dollars-  |  |
| UniSource Energy Stand-Alone  | \$ 2                            | \$ 68  | \$ 57  |
| TEP                           | 15                              | 106  | 94   |
| UNS Gas                       | 44                              |  | 70 <sup>(2)</sup>  |
| UNS Electric                  | 13                              | 4  | 66 <sup>(2)</sup>  |
| Other                         | 4 <sup>(3)</sup>                | N/A  | N/A  |
| Total                         | \$ 78                           |  |  |

(1) Includes LOCs issued under revolving credit facilities.

(2) Either UNS Gas or UNS Electric may borrow up to a maximum of \$70 million; the total combined amount borrowed by both companies cannot exceed \$100 million.

(3) Includes cash and cash equivalents at Millennium and UED.

**Dividends from Subsidiaries**

UNS Gas paid dividends of \$10 million to UniSource Energy during the first three months of 2012 and the first three months of 2011.

**Short-term Investments**

UniSource Energy's short-term investment policy governs the investment of excess cash balances. We regularly review and update this policy in response to market conditions. As of March 31, 2012, UniSource Energy's short-term investments included highly-rated and liquid money market funds and certificates of deposit.

**Access to Revolving Credit Facilities**

We have access to working capital through revolving credit agreements with lenders. Each of these agreements is a committed facility that expires in November 2016. The TEP Credit Agreement and UNS Gas/UNS Electric Revolver may be used for revolving borrowings as well as to issue letters of credit. TEP, UNS Gas, and UNS Electric each issue letters of credit from time to time to provide credit enhancement to counterparties for their energy procurement and hedging activities. The UniSource Credit Agreement also may be used to issue letters of credit for general corporate purposes.

We believe that we have sufficient liquidity under our revolving credit facilities to meet short-term working capital needs and to provide credit enhancement as necessary under energy procurement and hedging agreements. See *Item 3. Quantitative and Qualitative Disclosures about Market Risk*, below.

**UniSource Energy Consolidated Cash Flows**

| Three Months Ended March 31, | 2012                  | 2011  |
|------------------------------|-----------------------|-------|
|                              | -Millions of Dollars- |       |
| Operating Activities         | \$ 47                 | \$ 77 |
| Investing Activities         | (55)                  | (50)  |
| Financing Activities         | 7                     | (19)  |

UniSource Energy's operating cash flows are generated primarily by the retail and wholesale energy sales at TEP, UNS Gas, and UNS Electric, net of the related payments for fuel and purchased power. Generally, cash from operations is lowest in the first quarter and highest in the third quarter due to TEP's summer-peaking load. UniSource Energy, TEP, UNS Gas, and UNS Electric typically use their revolving credit facilities to fund their business activities during periods when sales are seasonally lower.

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Capital expenditures at TEP, UNS Gas, and UNS Electric represent the primary use of cash for investing activities. Cash used for investing and financing activities can fluctuate year-to-year depending on: capital expenditures; repayments and borrowings under revolving credit facilities; debt issuances or retirements; capital lease payments by TEP; and dividends paid by UniSource Energy to its shareholders.

**Table of Contents****Operating Activities**

In the first three months of 2012, net cash flows from operating activities were \$30 million lower than they were in the same period last year due to:

a \$34 million decrease in cash receipts from electric and gas sales (net of fuel and purchased energy costs) due in part to lower retail and long-term wholesale margins at TEP, and higher coal-related fuel costs paid at TEP; partially offset by

a \$4 million decrease in O&M costs and wages paid due in part to lower scheduled generating plant outage costs and lower incentive payments for renewable programs.

**Investing Activities**

Net cash flows used for investing activities increased by \$5 million in the first three months of 2012 compared with the same period last year. A \$10 million decrease in capital expenditures and the receipt of \$3 million in insurance proceeds for replacement assets were offset by a \$19 million decrease in proceeds from investments in Springerville lease debt compared with the first three months of 2011.

**Capital Expenditures**

|                               | <b>Actual</b>         |                  |
|-------------------------------|-----------------------|------------------|
|                               | <b>Year-to-Date</b>   | <b>Estimate</b>  |
|                               | <b>March 31,</b>      | <b>Full Year</b> |
|                               | <b>2012</b>           | <b>2012</b>      |
|                               | -Millions of Dollars- |                  |
| TEP                           | \$ 67                 | \$ 289           |
| UNS Gas                       | 3                     | 11               |
| UNS Electric                  | 9                     | 37               |
| UniSource Energy Consolidated | \$ 79                 | \$ 337           |

**Financing Activities**

Net cash flows from financing activities were \$26 million higher in the first three months of 2012 compared with the same period last year due primarily to a \$59 million increase in borrowings (net of repayments) under the UniSource Credit Agreement and TEP Revolving Credit Facility. This increase was partially offset by an \$18 million decrease in proceeds from the issuance of long-term debt (net of repayments) and a \$12 million increase in scheduled payments on capital lease obligations.

**UniSource Credit Agreement**

The UniSource Credit Agreement, which expires in November 2016, consists of a \$125 million revolving credit and revolving letter of credit facility. As of March 31, 2012, there was \$68 million outstanding at a weighted-average interest rate of 1.99%.

The UniSource Credit Agreement restricts additional indebtedness, liens, mergers, and sales of assets. The UniSource Credit Agreement also requires UniSource Energy to meet a minimum cash flow to interest coverage ratio determined on a UniSource Energy stand-alone basis. Additionally, UniSource Energy cannot exceed a maximum leverage ratio determined on a consolidated basis. Under the terms of the UniSource Credit Agreement, UniSource Energy may pay dividends so long as it maintains compliance with the agreement.

As of March 31, 2012, we were in compliance with the terms of the UniSource Credit Agreement.





**Table of Contents****Interest Rate Risk**

UniSource Energy is subject to interest rate risk resulting from changes in interest rates on its borrowings under the revolving credit facility. The interest paid on revolving credit borrowings is variable. UniSource Energy may be required to pay higher rates of interest on borrowings under its revolving credit facility if London Interbank Offered Rate (LIBOR) and other benchmark interest rates increase. See *Item 3. Quantitative and Qualitative Disclosures about Market Risk, Credit Risk*, below.

**Convertible Senior Notes**

In March 2005, UniSource Energy issued \$150 million of 4.50% Convertible Senior Notes due 2035. Each \$1,000 of Convertible Senior Notes can be converted into 29.001 shares of Common Stock at any time. The conversion ratio represents a conversion price of approximately \$34.48 per share of Common Stock and is subject to adjustments including an adjustment to reduce the conversion price upon the payment of quarterly dividends in excess of \$0.19 per share.

In December 2011 and March 2012, UniSource Energy issued two separate notices of partial redemption of the Convertible Senior Notes by calling a combined \$75 million of the \$150 million outstanding. Holders of the called Convertible Senior Notes had the option of converting their interests to Common Stock or redeeming the Convertible Senior Notes at par plus accrued interest. The notes were convertible into shares of Common Stock at a conversion rate applicable at the time of each notice. During the first three months of 2012, holders of approximately \$73 million of the Convertible Senior Notes selected for redemption converted their interests into approximately 2.1 million shares of Common Stock. The remaining \$2 million was redeemed for cash. As of March 31, 2012, there were approximately \$75 million of Convertible Senior Notes outstanding.

In April 2012, UniSource Energy issued a third notice of partial redemption of the Convertible Senior Notes by calling \$40 million of the approximately \$75 million that was outstanding as of March 31, 2012. Holders of approximately \$39 million of the Convertible Senior Notes selected for redemption converted their interests into approximately 1.1 million shares of Common Stock. The remaining \$1 million was redeemed for cash.

As of April 18, 2012, there were approximately \$35 million of Convertible Senior Notes outstanding.

The closing price of UniSource Energy's Common Stock was \$35.76 on April 18, 2012.

UniSource Energy has the option to redeem the remaining Convertible Senior Notes, in whole or in part, for cash, at a price equal to 100% of the principal amount plus accrued and unpaid interest. Holders of the Convertible Senior Notes will have the right to require UniSource Energy to repurchase the Convertible Senior Notes, in whole or in part, for cash on March 1, 2015, 2020, 2025, and 2030, or if certain specified fundamental changes involving UniSource Energy occur. The repurchase price will be 100% of the principal amount of the remaining notes plus accrued and unpaid interest.

**Contractual Obligations**

There are no significant changes in our contractual obligations or other commercial commitments from those reported in our 2011 Annual Report on Form 10-K, other than the following obligations established in 2012:

| Payment Due in Years Ending December 31,      | 2012                  | 2013 | 2014  | 2015 | 2016 | 2017      | Total |        |
|---|-----------------------|------|-------|------|------|-----------|-------|--------|
|   |                       |      |       |      |      | and after |       |        |
|   | -Millions of Dollars- |      |       |      |      |           |       |        |
| Long Term Debt <sup>(1)</sup>                 | \$                    | \$   | \$    | \$   | \$   | \$        | 177   | \$ 177 |
| Purchase Obligations:                         |                       |      |       |      |      |           |       |        |
| Fuel  | 2                     | 2    | 2     | 1    |      |           |       | 7      |
| Purchased Power                               |                       | 4    | 8     |      |      |           |       | 12     |
| Service Agreement                             | 2                     | 2    | 2     |      |      |           |       | 6      |
| Total Additional Contractual Cash Obligations | \$ 4                  | \$ 8 | \$ 12 | \$ 1 | \$   | \$        | 177   | \$ 202 |

- <sup>(1)</sup> In March 2012, \$177 million of unsecured tax-exempt pollution control bonds were issued on behalf of TEP. The bonds bear interest at a rate of 4.5% and are due in March 2030. Proceeds were deposited with a trustee and used in April 2012 to redeem \$177 million of 1998 Apache Bonds. See Note 4.

**Table of Contents****Dividends on Common Stock**

The following table shows the dividends declared to UniSource Energy shareholders for 2012:

| <b>Declaration Date</b> | <b>Record Date</b> | <b>Payment Date</b> | <b>Dividend Amount Per Share of Common Stock</b> |
|-------------------------|--------------------|---------------------|--|
| February 27, 2012       | March 12, 2012     | March 22, 2012      | \$0.43   |

**Income Tax Position**

As of March 31, 2012, UniSource Energy and TEP had the following carry-forward amounts:

|                            | <b>UniSource Energy</b>          |                      | <b>TEP</b>    |                      |
|----------------------------|----------------------------------|----------------------|---------------|----------------------|
|                            | <b>Amount</b>                    | <b>Expiring Year</b> | <b>Amount</b> | <b>Expiring Year</b> |
|                            | -Amounts in Millions of Dollars- |                      |               |                      |
| Capital Loss               | \$ 8                             | 2015                 | \$            |                      |
| Federal Net Operating Loss | 215                              | 2031                 | 212           | 2031-2032            |
| State Net Operating Loss   |                                  |                      | 13            | 2016-2017            |
| State Credits              | 1                                | 2016                 | 2             | 2016                 |
| AMT Credit                 | 43                               | None                 | 24            | None                 |

The 2010 Federal Tax Relief Act includes provisions that make qualified property placed into service between September 8, 2010 and January 1, 2012, eligible for 100% bonus depreciation for tax purposes. The same law makes qualified property placed in service during 2012 eligible for 50% bonus depreciation for tax purposes. This is an acceleration of tax benefits UniSource Energy otherwise would have received over 20 years. As a result of these provisions, UniSource Energy did not pay any federal income taxes for the tax year 2011 and does not expect to pay any federal income taxes for 2012.

**TUCSON ELECTRIC POWER COMPANY****RESULTS OF OPERATIONS**

TEP's financial condition and results of operations are the principal factors affecting the financial condition and results of operations of UniSource Energy. The following discussion relates to TEP's utility operations, unless otherwise noted.

**First Quarter of 2012 Compared with First Quarter of 2011**

TEP reported a net loss of \$1 million in the first quarter of 2012 compared with net income of \$5 million in the first quarter of 2011. The following factors impacted TEP's results in the first quarter of 2012:

a \$3 million decrease in retail margin revenues due to a 1.9% decrease in retail Kilowatt-hour (kWh) sales;

a \$5 million decline in long-term wholesale margin revenues resulting from a change in the pricing of energy sold under the SRP wholesale contract effective June 2011;

a \$2 million increase in depreciation expense as a result of an increase in plant-in-service; and

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a \$1 million increase in interest expense due in part to the issuance of \$250 million of fixed rate notes in 2011;  
partially offset by

a \$2 million decrease in Base O&M due in part to lower scheduled plant maintenance expenses.

**Table of Contents****Utility Sales and Revenues**

Changes in the number of customers, weather, economic conditions, and other consumption factors affect retail sales of electricity. The table below provides a summary of TEP's retail kWh sales, revenues, and weather data during the first quarters of 2012 and 2011:

| Three Months Ended March 31,                                 | 2012          | 2011          | Increase (Decrease) |                        |
|--|---------------|---------------|---------------------|------------------------|
| <u>Energy Sales, kWh (in millions)</u>                       |               |               | Amount              | Percent <sup>(1)</sup> |
| <b>Electric Retail Sales:</b>                                |               |               |                     |                        |
| Residential  | 730           | 749           | (19)                | (2.5%)                 |
| Commercial   | 396           | 401           | (5)                 | (1.4%)                 |
| Industrial   | 469           | 490           | (21)                | (4.3%)                 |
| Mining   | 273           | 265           | 8                   | 3.0%                   |
| Public Authorities   | 50            | 50            |                     | 0.7%                   |
| <b>Total Electric Retail Sales</b>                           | <b>1,918</b>  | <b>1,955</b>  | <b>(37)</b>         | <b>(1.9%)</b>          |
| <b>Retail Margin Revenues (in millions):</b>                 |               |               |                     |                        |
| Residential  | \$ 46         | \$ 47         | \$ (1)              | (1.7%)                 |
| Commercial   | 31            | 31            |                     | (1.3%)                 |
| Industrial   | 20            | 21            | (1)                 | (4.9%)                 |
| Mining   | 6             | 7             | (1)                 | (14.5%)                |
| Public Authorities   | 2             | 2             |                     | NM                     |
| <b>Total Retail Margin Revenues (Non-GAAP)<sup>(2)</sup></b> | <b>\$ 105</b> | <b>\$ 108</b> | <b>\$ (3)</b>       | <b>(3.0%)</b>          |
| <b>Fuel and Purchased Power Revenues</b>                     | <b>49</b>     | <b>50</b>     | <b>(1)</b>          | <b>(1.8%)</b>          |
| <b>RES &amp; DSM Revenues</b>                                | <b>12</b>     | <b>15</b>     | <b>(3)</b>          | <b>(21.3%)</b>         |
| <b>Total Retail Revenues (GAAP)</b>                          | <b>\$ 166</b> | <b>\$ 173</b> | <b>\$ (7)</b>       | <b>(4.3%)</b>          |
| <b>Average Retail Margin Rate (cents / kWh):</b>             |               |               |                     |                        |
| Residential  | 6.31          | 6.26          | 0.05                | 0.8%                   |
| Commercial   | 7.76          | 7.75          | 0.01                | 0.1%                   |
| Industrial   | 4.18          | 4.21          | (0.03)              | (0.7%)                 |
| Mining   | 2.38          | 2.87          | (0.49)              | (17.1%)                |
| Public Authorities   | 4.98          | 5.01          | (0.03)              | (0.6%)                 |
| <b>Average Retail Margin Revenue</b>                         | <b>5.50</b>   | <b>5.56</b>   | <b>(0.06)</b>       | <b>(1.1%)</b>          |
| <b>Average Fuel and Purchased Power Revenue</b>              | <b>2.56</b>   | <b>2.56</b>   |                     | <b>NM</b>              |
| <b>Average RES &amp; DSM Revenue</b>                         | <b>0.62</b>   | <b>0.77</b>   | <b>(0.15)</b>       | <b>(19.5%)</b>         |
| <b>Total Average Retail Revenue</b>                          | <b>8.68</b>   | <b>8.89</b>   | <b>(0.21)</b>       | <b>(2.5%)</b>          |
|  | <b>2012</b>   | <b>2011</b>   |                     |                        |
| <b>Weather Data:</b>   |               |               |                     |                        |
| <b>Heating Degree Days</b>                                   |               |               |                     |                        |
| Three Months Ended March 31                                  | 739           | 856           | (117)               | (13.7%)                |
| 10-Year Average  | 795           | 813           | NM                  | NM                     |

(1) Percent change calculated on unrounded data and may not correspond exactly to data shown in table.

(2)

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Retail Margin Revenues, a non-GAAP financial measure, should not be considered as an alternative to Net Electric Retail Sales, which is determined in accordance with GAAP. Retail Margin Revenues exclude: (i) revenues collected from retail customers that are directly offset by expenses recorded in other line items; and (ii) revenues collected from third parties that are unrelated to kWh sales to retail customers. We believe the change in Retail Margin Revenues between periods provides useful information to investors because it demonstrates the underlying revenue trend and performance of our core utility business. Retail Margin Revenues represents the portion of retail operating revenues available to cover the non-fuel operating expenses of our core utility business.

### Residential

Residential kWh sales were 2.5% lower in the first quarter of 2012 than they were during the same period last year, leading to a decrease in residential margin revenues of 1.7%, or \$1 million. Residential use per customer decreased by 2.8% due in part to a 13.7% decline in Heating Degree Days compared with the same period last year. The average number of residential customers grew by 0.3% in the first quarter of 2012 compared with the same period last year.

**Table of Contents****Commercial**

Commercial kWh sales fell by 1.4% compared with the first quarter of 2011, leading to a decline in margin revenues by 1.3%. Commercial use per customer decreased by 2.1% compared with the first quarter of 2011. The average number of commercial customers grew by 0.8% in the first quarter of 2012 compared with the same period last year.

**Industrial**

Industrial kWh sales decreased by 4.3% compared with the first quarter of 2011. Industrial margin revenues declined by 4.9% when compared with the same period of 2011. The decline in margin revenues was greater than the change in kWh sales due to changing usage patterns by certain industrial customers that reduced their demand charges paid to TEP.

**Mining**

Mining kWh sales increased by 3.0% in the first quarter of 2012 compared with the same period last year due to continued high copper prices. Despite higher sales, first quarter 2012 margin revenues from mining customers were approximately \$1 million lower than in the first quarter of 2011. In December 2011, a mining customer's long-term contract expired and in January 2012 the customer converted to a time-of-use rate. As a result, we expect this rate change to reduce full year 2012 margin revenues from mining customers by approximately \$1 million compared with 2011.

**Wholesale Sales and Transmission Revenues**

| Three Months Ended March 31,   | 2012                  | 2011         |
|--|-----------------------|--------------|
|  | -Millions of Dollars- |              |
| <b>Long-Term Wholesale Revenues:</b>                                       |                       |              |
| Long-Term Wholesale Margin Revenues (Non-GAAP) <sup>(1)</sup>              | \$ 2                  | \$ 7         |
| Fuel and Purchased Power Expense Allocated to Long-Term Wholesale Revenues | 5                     | 6            |
| Total Long-Term Wholesale Revenues   | 7                     | 13           |
| Transmission Revenues  | 4                     | 4            |
| Short-Term Wholesale Revenues  | 19                    | 18           |
| <b>Electric Wholesale Sales (GAAP)</b>                                     | <b>\$ 30</b>          | <b>\$ 35</b> |

<sup>(1)</sup> Long-term wholesale margin revenues, a non-GAAP financial measure, should not be considered as an alternative to Electric Wholesale Sales, which is determined in accordance with GAAP. We believe the change in Long-Term Wholesale Margin Revenues between periods provides useful information to investors because it demonstrates the underlying profitability of TEP's long-term wholesale sales contracts. Long-Term Wholesale Margin Revenues represents the portion of long-term wholesale revenues available to cover the operating expenses of our core utility business.

Long-term wholesale margin revenues were \$5 million lower than in the first quarter of 2011. The decrease was due primarily to a change in pricing under the SRP contract. See *Factors Affecting Results of Operations, Long-Term Wholesale Sales, Salt River Project*, below, for more information.

TEP credits all revenues from short-term wholesale sales and 90% of the margin on wholesale trading activity against the fuel and purchased power costs eligible for recovery in the Purchased Power and Fuel Adjustment Clause (PPFAC). There was no wholesale trading activity during the first three months of 2012 or during the first three months of 2011.

**Table of Contents****Other Revenues**

| Three Months Ended March 31,                                  | 2012                  | 2011         |
|---|-----------------------|--------------|
|   | -Millions of Dollars- |              |
| Revenue Related to Springerville Units 3 and 4 <sup>(1)</sup> | \$ 21                 | \$ 24        |
| Other Revenue   | 7                     | 7            |
| <b>Total Other Revenue</b>                                    | <b>\$ 28</b>          | <b>\$ 31</b> |

<sup>(1)</sup> Represents revenues and reimbursements from the owners of Springerville Units 3 and 4 to TEP related to the operation of these plants. In addition to reimbursements related to Springerville Units 3 and 4, TEP's other revenues include: inter-company revenues from UNS Gas and UNS Electric for corporate services provided by TEP; and miscellaneous service-related revenues such as rent on power pole attachments, damage claims, and customer late fees.

**Operating Expenses****Fuel and Purchased Power Expense**

TEP's fuel and purchased power expense and energy resources for the first quarters of 2012 and 2011 are detailed below:

| Three Months Ended March 31,                            | Generation and<br>Purchased Power |              | Fuel and Purchased<br>Power Expense |              |
|---|-----------------------------------|--------------|-------------------------------------|--------------|
|   | 2012                              | 2011         | 2012                                | 2011         |
|   | -Millions of kWh-                 |              | -Millions of Dollars-               |              |
| Coal-Fired Generation                                   | 2,337                             | 2,365        | \$ 57                               | \$ 57        |
| Gas-Fired Generation                                    | 290                               | 175          | 11                                  | 11           |
| Renewable Generation                                    | 15                                | 7            |                                     |              |
| <b>Total Generation</b>                                 | <b>2,642</b>                      | <b>2,547</b> | <b>68</b>                           | <b>68</b>    |
| <b>Total Purchased Power</b>                            | <b>446</b>                        | <b>470</b>   | <b>14</b>                           | <b>17</b>    |
| Reimbursed Fuel Expense for Springerville Units 3 and 4 |                                   |              | 2                                   | 2            |
| Transmission  |                                   |              | 1                                   | 1            |
| Decrease to Reflect PPFAC Recovery Treatment            |                                   |              | (8)                                 | (9)          |
| <b>Total Resources</b>                                  | <b>3,088</b>                      | <b>3,017</b> | <b>\$ 77</b>                        | <b>\$ 79</b> |
| Less Line Losses and Company Use                        | (195)                             | (175)        |                                     |              |
| <b>Total Energy Sold</b>                                | <b>2,893</b>                      | <b>2,842</b> |                                     |              |

**Generation**

Total generating output increased during the first quarter of 2012 compared with the same period last year. Coal-fired generation decreased by 1% in the first quarter of 2012 due in part to the use of natural gas to fuel Sundt Unit 4 instead of coal. Fueling Sundt Unit 4 with natural gas during the first quarter of 2012 was more economic than using higher priced contracted coal.

**Purchased Power**



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Purchased power volumes decreased in the first quarter of 2012 compared with the same period last year due to increased generating output at our gas stations.

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The table below summarizes TEP's cost per kWh generated or purchased:

| Three Months Ended March 31, | 2012            | 2011 |
|------------------------------|-----------------|------|
|                              | -cents per kWh- |      |
| Coal                         | 2.45            | 2.42 |
| Gas                          | 3.70            | 6.20 |
| Purchased Power              | 3.05            | 3.66 |
| All Sources                  | 2.66            | 2.80 |

**Market Prices**

As a participant in the western U.S. wholesale power markets, TEP is directly and indirectly affected by changes in market conditions. The average market price for around-the-clock energy based on the Dow Jones Palo Verde Market Index in the first quarter of 2012 was 18% below the same period in 2011. The average price for natural gas based on the Permian Index in the first quarter of 2012 was lower by 32% compared with the same periods in 2011. We cannot predict whether changes in various factors that influence demand and supply will cause prices to change during the remainder of 2012.

| Average Market Price for Around-the-Clock Energy | \$/MWh   |
|--|----------|
| Quarter ended March 31, 2012                     | \$ 22    |
| Quarter ended March 31, 2011                     | 27       |
| Average Market Price for Natural Gas             | \$/MMBtu |
| Quarter ended March 31, 2012                     | \$ 2.67  |
| Quarter ended March 31, 2011                     | 3.92     |

**O&M**

The table below summarizes the items included in TEP's O&M:

| Three Months Ended March 31,  | 2012                  | 2011  |
|---|-----------------------|-------|
|   | -Millions of Dollars- |       |
| Base O&M (Non-GAAP) <sup>(1)</sup>                                    | \$ 60                 | \$ 62 |
| O&M Recorded in Other Expense   | (1)                   | (2)   |
| Reimbursed Expenses Related to Springerville Units 3 and 4            | 13                    | 16    |
| Expenses Related to Customer-Funded Renewable Energy and DSM Programs | 10                    | 12    |
| Total Other O&M (GAAP)  | \$ 82                 | \$ 88 |

<sup>(1)</sup> Base O&M, a non-GAAP financial measure, should not be considered as an alternative to Other O&M, which is determined in accordance with GAAP. We believe Base O&M provides useful information to investors because it represents the fundamental level of operating and maintenance expense related to our business. Base O&M excludes expenses that are directly offset by revenues collected from customers and other third parties.

**FACTORS AFFECTING RESULTS OF OPERATIONS****Base Rate Increase Moratorium**

Pursuant to the 2008 TEP Rate Order issued by the Arizona Corporation Commission (ACC), TEP's Base Rates are frozen through at least December 31, 2012. TEP is prohibited from submitting an application for new Base Rates before June 30, 2012. See *2012 TEP Rate Case*,

below, for more information.

Notwithstanding the rate increase moratorium, Base Rates and adjustor mechanisms may change under emergency conditions beyond TEP's control if the ACC concludes such changes are required to protect the public interest. The moratorium does not preclude TEP from seeking rate relief in the event of the imposition of a federal carbon tax or related federal carbon regulations.

**Table of Contents****2012 TEP Rate Case**

In April 2012, TEP filed a notice with the ACC indicating that it intends to file a rate case application on or about July 2, 2012. The notice included an overview of certain issues TEP expects to raise in its rate case filing including: the use of a December 31, 2011 test year; the need for a mechanism that allows TEP to recover lost fixed costs based on the approved levels established in the rate filing; and an environmental compliance cost recovery mechanism to provide appropriate cost recovery related to capital investments necessary to comply with government-mandated environmental standards.

As part of the 2008 TEP Rate Order, TEP, ACC Staff, and other parties agreed to use best efforts to implement new rates no later than 13 months after TEP's rate application is filed with the ACC. In accordance with this provision, TEP's 2012 rate case application will propose that new rates go into effect no later than August 1, 2013.

**Purchased Power and Fuel Adjustment Clause**

In February 2012, TEP filed its annual PPFAC update report with the ACC. TEP requested an increase in the total PPFAC rate of \$77 million to recover under-collected fuel and purchased power costs of approximately \$51 million and an increase in forecasted fuel and purchased power costs of approximately \$26 million. In March 2012, the ACC approved a PPFAC rate of 0.77 cents per kWh effective April 2012. The new PPFAC rate is expected to provide recovery of approximately \$70 million of fuel and purchased power costs over the period of April 2012 through March 2013. Any shortfall not collected under the approved PPFAC rate is expected to be recovered through the PPFAC rate set for the period beginning April 1, 2013.

On April 23, 2012, an advocacy group that represents some of TEP's non-residential customers filed a request with the ACC asking it to consider modifying the recovery period of TEP's PPFAC rate. TEP cannot predict if the ACC will act on this filing.

**Springerville Units 3 and 4**

TEP operates and receives annual benefits in the form of rental payments and other fees and cost savings from operating Springerville Unit 3 on behalf of Tri-State and Springerville Unit 4 on behalf of SRP. TEP recorded pre-tax income of \$6 million in the first quarters of 2012 and 2011 related to the operation of these units. The table below summarizes the income statement line items in which TEP records revenues and expenses related to Springerville Units 3 and 4:

| Three Months Ended March 31, | 2012                  | 2011  |
|------------------------------|-----------------------|-------|
|                              | -Millions of Dollars- |       |
| Other Revenues               | \$ 21                 | \$ 24 |
| Fuel Expense                 | (2)                   | (2)   |
| O&M                          | (13)                  | (16)  |
| Total Pre-Tax Income         | \$ 6                  | \$ 6  |

**Pension and Postretirement Benefit Expense**

The table below summarizes TEP's pension and other postretirement benefit expenses recorded as part of Other O&M in 2012 and 2011. See Note 7 for more information.

| Three Months Ended March 31,                        | 2012                  | 2011 |
|---|-----------------------|------|
|   | -Millions of Dollars- |      |
| Pension Expense Charged to O&M                      | \$ 3                  | \$ 2 |
| Other Postretirement Benefit Expense Charged to O&M | 1                     | 1    |
| Total   | \$ 4                  | \$ 3 |

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In 2012, TEP expects to record approximately \$10 million of pension and \$5 million of other postretirement benefit expense as part of O&M.

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### **Long-Term Wholesale Sales**

TEP's two primary long-term wholesale contracts are with SRP and NTUA. TEP's margin on long-term wholesale sales was \$2 million during the first three months of 2012, compared with \$7 million in the same period last year.

TEP estimates its margin on long-term wholesale sales in 2012 will be \$6 million, compared with \$13 million in 2011. The decrease is a result of changes in the terms of the SRP contract described below.

### **Salt River Project**

Prior to June 2011, under the terms of the SRP contract, TEP received a monthly demand charge of approximately \$1.8 million, or \$22 million annually, and sold the energy at a price based on TEP's average fuel cost. From June 2011 to December 2011, SRP was required to purchase 73,000 MWh per month. From January 1, 2012 through the end of the contract in May 2016, SRP is required to purchase 500,000 MWh of on-peak energy per year. TEP does not receive a demand charge and the price of energy is based on a discount to the price of on-peak power on the Dow Jones Palo Verde Market Index. As of April 18, 2012, the average forward price of on-peak power on the Dow Jones Palo Verde Market Index for the rest of calendar year 2012 was \$29 per MWh. A change of \$5 per MWh in on-peak market price of power on the Dow Jones Palo Verde Market Index would change annual pre-tax income by approximately \$3 million.

### **Navajo Tribal Utility Authority**

TEP serves the portion of NTUA's load that is not served from NTUA's allocation of federal hydroelectric power. Over the last three years, sales to NTUA averaged 225,000 MWh. The price of 50% of the MWh sales from June to September is based on the Dow Jones Palo Verde Market Index. Similarly to 2011, we expect approximately 12% of the total energy sold to NTUA in 2012 will be priced based on the Dow Jones Palo Verde Market Index. The remaining power sales occur at a fixed price under TEP's contract with NTUA.

### **Electric Energy Efficiency Standards**

In August 2010, the ACC approved new Electric Energy Efficiency Standards (EE Standards) designed to require TEP, UNS Electric, and other affected electric utilities to implement cost-effective programs to reduce customers' energy consumption. In 2011, TEP's programs saved energy equal to approximately 1.4% of its 2010 sales. In 2012, the EE Standards target total kWh savings of 3% of 2011 sales. The Electric EE Standards increase annually thereafter up to a targeted cumulative annual reduction in retail kWh sales of 22% by 2020.

The EE Standards can be met by new and existing DSM programs, direct load control programs and energy efficient building codes. The EE Standards provide for the recovery of costs incurred to implement DSM programs. TEP's programs, and Retail Rates charged to customers for such programs, are subject to annual review and approval by the ACC.

In January 2012, TEP filed a modification to its proposed 2011-2012 Energy Efficiency Implementation Plan with the ACC. The proposal includes a request for an increase in the performance incentive based on TEP's ability to meet the Electric EE Standards for 2012 and for 2013. TEP's proposed annual performance incentive for 2012 and 2013 ranges from \$6 million to \$8 million. In March 2012, the ACC voted to send this matter to a hearing in order to gather more information.

In April 2012, TEP informed the ACC that TEP is not requesting an adjustment to the current DSM surcharge of approximately 0.12 cents per kWh. TEP expects to use the surcharge to fund approximately \$8 million for certain existing DSM programs and approximately \$9 million of unrecovered historical DSM costs. These programs and costs have been previously authorized by the ACC for recovery through the DSM surcharge. TEP cannot predict if the ACC will act on this filing.

### **Decoupling**

In December 2010, the ACC issued a policy statement recognizing the need to adopt rate decoupling or another mechanism to make Arizona's EE Standards viable. A decoupling mechanism is designed to encourage energy conservation by restructuring utility Retail Rates to separate the recovery of fixed costs from the level of energy consumed. The policy statement allows affected utilities to file rate decoupling proposals in their next general rate case. TEP expects to file its next general rate case in July 2012. See *2012 TEP Rate Case*, above.



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### **Competition**

New technological developments and the implementation of EE Standards may reduce energy consumption by TEP's retail customers. TEP's customers also have the ability to install renewable energy technologies and conventional generation units that could reduce their reliance on TEP's services. Self-generation by TEP's customers has not had a significant impact to date. In the wholesale market, TEP competes with other utilities, power marketers, and independent power producers in the sale of electric capacity and energy.

### **Renewable Energy Standard and Tariff**

In December 2011, the ACC approved TEP's RES implementation plan including investments of \$28 million in 2012 and \$8 million in 2013 for company-owned solar projects. In 2011, TEP's renewable energy investments totaled \$28 million. In accordance with the funding mechanism approved by the ACC, TEP could earn approximately \$1 million pre-tax in 2012 on solar investments made in 2010 and 2011 and approximately \$4 million pre-tax in 2013.

### **Sales to Mining Customers**

In the first three months of 2012, kWh sales to TEP's mining customers increased 3.0% compared with the same period last year. See *Utility Sales and Revenues, Mining*, above for more information.

The continuation of copper prices of \$3 per pound has led to increased mining activity at the copper mines operating in TEP's service area. TEP's mining customers have indicated they are taking initial steps to increase production either through expansion of their current mining operations or by the re-opening of non-operational mine sites. If efforts to increase production are successful, TEP's mining load could increase by up to 100 MW over the next several years. The market price for copper and the ability to obtain necessary permits could affect the mining industry's expansion plans.

In addition to the mining customers TEP currently serves, in 2007, Augusta Resources Corporation filed a plan of operations with the United States Forest Service for the proposed Rosemont Copper Mine near Tucson, Arizona. The Rosemont Copper Mine requires electric service from TEP via a 138kV transmission line for the construction and ongoing operation of the mine. A certificate of environmental compatibility (CEC) from the state line siting committee was approved in December 2011 for the 138 kV transmission line. In March 2012, the ACC conditionally approved the CEC but required additional hearings before an administrative law judge. If the Rosemont Copper Mine reaches full production, it would become TEP's largest retail customer. TEP would serve approximately 100 MW of the Rosemont Copper Mine's total estimated load of approximately 110 MW.

TEP cannot predict if or when existing mines will expand operations or new or re-opened mines will commence operations.

### **Interest Rates**

TEP is exposed to interest rate risk resulting from changes in interest rates on certain of its variable rate debt obligations, as well as borrowings under its revolving credit facility. As a result, TEP may be required to pay significantly higher rates of interest on outstanding variable rate debt and borrowings under its revolving credit facility. At March 31, 2012, TEP had \$215 million in tax-exempt variable rate debt outstanding. The interest rates on TEP's tax-exempt variable rate debt are reset weekly by its remarketing agents. The maximum interest payable under the indentures for the bonds is 10% on \$37 million of bonds and 20% on the other \$178 million. During the first three months of 2012, the average rates paid ranged from 0.06% to 0.18%. At April 18, 2012, the average rate on the debt was 0.24%.

TEP has a fixed-for-floating interest rate swap in place to hedge \$50 million of its tax-exempt variable rate debt.

TEP is also subject to interest rate risk resulting from changes in interest rates on its borrowings under the revolving credit facility. The interest paid on revolving credit borrowings is variable. If LIBOR and other benchmark interest rates increase, TEP may be required to pay higher rates of interest on borrowings under its revolving credit facility. See Item 3. *Quantitative and Qualitative Disclosures about Market Risk, Interest Rate Risk*, below.



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### **San Juan Mine Fire**

In September 2011, a fire at the underground mine that provides coal to San Juan Generating Station (San Juan) caused mining operations to shut down. TEP owns approximately 20% of San Juan, which is operated by PNM. The mine operator estimates that mining operations are expected to resume to full production in May 2012.

Based on information we have received to date, TEP does not expect the mine fire to have a material effect on TEP's financial condition, results of operations, or cash flows due to the current inventory of previously mined coal and the current low market price of wholesale power. TEP expects that any incremental fuel and purchased power costs would be recoverable from customers through the PPFAC, subject to ACC approval.

### **Retail Electric Competition Rules**

In 1999, the ACC approved the Retail Electric Competition Rules (Rules) that provided a framework for the introduction of retail electric competition in Arizona. Certain portions of the ACC Rules that enabled Electric Service Providers (ESPs) to compete in the retail market were invalidated by an Arizona Court of Appeals decision in 2004. In 2008, the ACC opened an administrative proceeding to address the Rules but has since taken no action. In March 2012, Constellation NewEnergy filed an application for a Certificate of Convenience and Necessity (CC&N) with the ACC to provide competitive retail electric services in TEP's service territory as an ESP. Unless and until the ACC clarifies the Rules and/or grants a CC&N to an ESP, it is not possible for TEP's retail customers to use an alternative ESP. We cannot predict what changes, if any, the ACC will make to the Rules or if the ACC will grant a CC&N to an ESP.

### **Fair Value Measurements**

TEP's income statement exposure to energy price risk is mitigated as TEP reports the change in fair value of energy contract derivatives as a regulatory asset or a regulatory liability, or as a component in the statements of other comprehensive income, rather than in the income statement. See Note 9.

**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES****TEP Cash Flows**

The tables below show the cash available to TEP after capital expenditures, scheduled debt payments, and payments on capital lease obligations:

| Three Months Ended March 31,  | 2012                  | 2011    |
|---|-----------------------|---------|
|   | -Millions of Dollars- |         |
| Net Cash Flows Operating Activities (GAAP)  | \$ 22                 | \$ 53   |
| Amounts from Statements of Cash Flows:  |                       |         |
| Less: Capital Expenditures  | (67)                  | (66)    |
| Net Cash Flows after Capital Expenditures (Non-GAAP) <sup>(1)</sup>   | (45)                  | (13)    |
| Amounts From Statements of Cash Flows:  |                       |         |
| Less: Retirement of Capital Lease Obligations   | (74)                  | (62)    |
| Plus: Proceeds from Investment in Lease Debt  | 19                    | 38      |
| Net Cash Flows after Capital Expenditures and Required Payments on Debt and Capital Lease Obligations (Non-GAAP) <sup>(1)</sup> | \$ (100)              | \$ (37) |

| Three Months Ended March 31,  | 2012                  | 2011  |
|---|-----------------------|-------|
|   | -Millions of Dollars- |       |
| Net Cash Flows Operating Activities (GAAP)  | \$ 22                 | \$ 53 |
| Net Cash Flows Investing Activities (GAAP)  | (43)                  | (27)  |
| Net Cash Flows Financing Activities (GAAP)  | 13                    | (26)  |
| Net Cash Flows after Capital Expenditures (Non-GAAP) <sup>(1)</sup>   | (45)                  | (13)  |
| Net Cash Flows after Capital Expenditures and Required Payments on Debt and Capital Lease Obligations (Non-GAAP) <sup>(1)</sup> | (100)                 | (37)  |

<sup>(1)</sup> Net Cash Flows after Capital Expenditures and Net Cash Flows Available after Capital Expenditures and Required Payments on Debt and Capital Lease Obligations, both non-GAAP measures of liquidity, should not be considered as alternatives to Net Cash Flows Operating Activities, which is determined in accordance with GAAP. We believe that Net Cash Flows after Capital Expenditures and Net Cash Flows Available after Capital Expenditures and Required Payments on Debt and Capital Lease Obligations provide useful information to investors as measures of TEP's ability to fund capital requirements, make required principal payments on debt and capital lease obligations (net), and pay dividends to UniSource Energy.

**Liquidity Outlook**

During 2012, TEP expects to generate sufficient internal cash flows to fund the majority of its capital expenditures and operating activities. Cash flows may vary during the year, with cash flow from operations typically the lowest in the first quarter and highest in the third quarter due to TEP's summer peaking load. As a result of the varied seasonal cash flow, TEP will use, as needed, its revolving credit facility to fund its business activities.

**Operating Activities**

In the first three months of 2012, net cash flows from operating activities were \$31 million lower than in the first three months of 2011 due primarily to:

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a \$34 million decrease in cash receipts from electric sales (net of fuel and purchased power costs) due in part to lower retail and long-term wholesale margins and higher coal-related fuel costs paid compared with the first three months of 2011; partially offset by

a \$4 million decrease in O&M costs and wages paid due in part to lower generating plant outage costs, and lower incentive payments for renewable programs.

### **Investing Activities**

Net cash flows used for investing activities increased by \$16 million in the first three months of 2012 compared with the same period last year. Proceeds from the return of investment in Springerville lease debt decreased by \$19 million in the first three months of 2012 compared with the same period last year.

TEP's capital expenditures were \$67 million in the first three months of 2012, compared with \$66 million in the same period last year. TEP's estimated capital expenditures for 2012 are \$289 million.

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### **Financing Activities**

In the first three months of 2012, net cash from financing activities was \$39 million higher than in the same period in 2011 due to:

a \$70 million increase in borrowings (net of repayments) made under TEP's Revolving Credit Facility to fund in part capital lease payments;  
partially offset by

an \$18 million decrease in proceeds from the issuance of long-term debt (net of repayments); and

a \$12 million increase in scheduled payments on capital lease obligations.

### **TEP Credit Agreement**

The TEP Credit Agreement consists of a \$200 million revolving credit and revolving letter of credit facility and a \$186 million letter of credit facility to support tax-exempt bonds. The TEP Credit Agreement expires in November 2016 and is secured by \$386 million of Mortgage Bonds. As of March 31, 2012, there was \$105 million of outstanding borrowings and \$1 million of letters of credit issued under the TEP Revolving Credit Facility.

The TEP Credit Agreement contains restrictions on liens, mergers, and sale of assets. The TEP Credit Agreement also requires TEP not to exceed a maximum leverage ratio. If TEP complies with the terms of the TEP Credit Agreement, TEP may pay dividends to UniSource Energy. As of March 31, 2012, TEP was in compliance with the terms of the TEP Credit Agreement.

### **2010 TEP Reimbursement Agreement**

In December 2010, TEP entered into a four-year \$37 million reimbursement agreement (2010 TEP Reimbursement Agreement). A \$37 million letter of credit was issued pursuant to the 2010 TEP Reimbursement Agreement. The letter of credit supports \$37 million aggregate principal amount of variable rate tax-exempt Industrial Development Bonds that were issued on behalf of TEP in December 2010.

The 2010 TEP Reimbursement Agreement contains substantially the same restrictive covenants as the TEP Credit Agreement described above. As of March 31, 2012, TEP was in compliance with the terms of the 2010 TEP Reimbursement Agreement.

### **2012 Bond Issuances and Redemptions**

In March 2012, \$177 million of unsecured tax-exempt pollution control bonds were issued on behalf of TEP. The bonds bear interest at a fixed rate of 4.50%, mature in March 2030 and may be redeemed at par on or after March 1, 2022. In April 2012, the proceeds of the bond issuance, as well as \$7 million of internal cash, were used to redeem \$184 million of unsecured tax-exempt bonds with interest rates of 5.85% and 5.875%, and maturity dates ranging from 2026 to 2033. See Note 4.

**Table of Contents****Capital Lease Obligations**

As of March 31, 2012, TEP had \$361 million of total capital lease obligations on its balance sheet. The table below provides a summary of the outstanding lease obligations:

| Leases   | Capital Lease Obligation     |                       | Expiration    | Renewal/Purchase Option   |
|--|------------------------------|-----------------------|---------------|---|
|  | Balance As of March 31, 2012 | -Millions of Dollars- |               |   |
| Springerville Unit 1 <sup>(1)</sup>            | \$                           | 191                   | 2015          | Fair market value purchase option of \$159 million <sup>(2)</sup> |
| Springerville Coal Handling Facilities Lease   |                              | 61                    | 2015          | Fixed price purchase option of \$120 million <sup>(3)</sup>       |
| Springerville Common Facilities <sup>(4)</sup> |                              | 109                   | 2017 and 2021 | Fixed price purchase option of \$106 million <sup>(3)</sup>       |
| Total Capital Lease Obligations                | \$                           | 361                   |               |   |

(1) The Springerville Unit 1 Leases cover both Unit 1 and an undivided one-half interest in certain Springerville Common Facilities.

(2) As determined in December 2011 in an appraisal procedure undertaken pursuant to the Springerville Unit 1 lease agreements.

(3) TEP agreed with Tri-State, the owner of Springerville Unit 3 and SRP, the owner of Springerville Unit 4, that if the Springerville Coal Handling Facilities and Common Leases are not renewed, TEP will exercise the purchase options under these contracts. SRP will then be obligated to buy a portion of these facilities and Tri State will then be obligated to either 1) buy a portion of these facilities; or 2) continue making payments to TEP for the use of these facilities.

(4) The Springerville Common Facilities Leases cover an undivided one-half interest in certain Springerville Common Facilities.

Except for TEP's 14% equity ownership in Springerville Unit 1 and its 13% equity ownership in the Springerville Coal Handling Facilities, TEP will not own these assets at the expiration of the leases. TEP may renew the leases or purchase the leased assets at such time. The renewal and purchase option for Springerville Unit 1 and associated Common Facilities is for fair market value as determined at that time, whereas the purchase price option is fixed for the Springerville Coal Handling Facilities and the remaining Common Facilities.

**Income Tax Position**

See *UniSource Energy Consolidated, Liquidity and Capital Resources, Income Tax Position*, above.

**Contractual Obligations**

There have been no significant changes in TEP's contractual obligations or other commercial commitments from those reported in our 2011 Annual Report on Form 10-K, other than the following obligations established in 2012:

| Payment Due in Years Ending December 31, | 2017 |      |      |      |      |           | Total |
|--|------|------|------|------|------|-----------|-------|
|  | 2012 | 2013 | 2014 | 2015 | 2016 | and after |       |

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|  | -Millions of Dollars- |             |             |           |           |           |           |            |               |
|--|-----------------------|-------------|-------------|-----------|-----------|-----------|-----------|------------|---------------|
| Long Term Debt <sup>(1)</sup>                        | \$                    | \$          | \$          | \$        | \$        | \$        | \$        | 177        | \$ 177        |
| Purchase Obligations                                 |                       |             |             |           |           |           |           |            |               |
| Purchased Power                                      |                       |             | 4           |           |           |           |           |            | 4             |
| Service Agreement                                    | 2                     | 2           | 2           |           |           |           |           |            | 6             |
| <b>Total Additional Contractual Cash Obligations</b> | <b>\$ 2</b>           | <b>\$ 6</b> | <b>\$ 2</b> | <b>\$</b> | <b>\$</b> | <b>\$</b> | <b>\$</b> | <b>177</b> | <b>\$ 187</b> |

<sup>(1)</sup> In March 2012, \$177 million of unsecured tax-exempt pollution control bonds were issued on behalf of TEP. The bonds bear interest at a rate of 4.5% and are due in March 2030. Proceeds were deposited with a trustee and used in April 2012, together with \$7 million of internal cash, to redeem \$184 million of 1998 Apache Bonds issued on behalf of TEP. See Note 4.

**Table of Contents****Dividends on Common Stock**

TEP can pay dividends if it maintains compliance with the TEP Credit Agreement and the 2010 TEP Reimbursement Agreement. As of March 31, 2012, TEP was in compliance with the terms of the TEP Credit Agreement and the 2010 TEP Reimbursement Agreement.

The Federal Power Act states that dividends shall not be paid out of funds properly included in capital accounts. Although the terms of the Federal Power Act are unclear, we believe there is a reasonable basis for TEP to pay dividends from current year earnings.

**UNS GAS****RESULTS OF OPERATIONS**

UNS Gas reported net income of \$5 million in the first quarter 2012 and \$6 million in the same quarter of 2011. The table below provides summary financial information for UNS Gas:

| <b>Three Months Ended March 31,</b>                                 | <b>2012</b>           | <b>2011</b> |
|---|-----------------------|-------------|
|   | -Millions of Dollars- |             |
| Gas Retail Revenues   | \$ 51                 | \$ 58       |
| Other Revenues  | 2                     | 1           |
| <b>Total Operating Revenues</b>                                     | <b>53</b>             | <b>59</b>   |
| Purchased Gas Expense   | 29                    | 37          |
| Increase to Reflect Purchased Gas Adjustor (PGA) Recovery Treatment | 3                     |             |
| O&M   | 7                     | 7           |
| Depreciation and Amortization                                       | 2                     | 2           |
| Taxes Other Than Income Taxes                                       | 1                     | 1           |
| <b>Total Other Operating Expenses</b>                               | <b>42</b>             | <b>47</b>   |
| Operating Income  | 11                    | 12          |
| Total Interest Expense  | 2                     | 2           |
| Income Tax Expense  | 4                     | 4           |
| <b>Net Income</b>   | <b>\$ 5</b>           | <b>\$ 6</b> |

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The table below includes UNS Gas therm sales and margin revenues for the first quarters of 2012 and 2011:

| Three Months Ended March 31,                                 | 2012         | 2011         | Increase (Decrease) |                        |
|--|--------------|--------------|---------------------|------------------------|
|  |              |              | Amount              | Percent <sup>(1)</sup> |
| -Millions of Therms-   |              |              |                     |                        |
| <b>Gas Retail Sales:</b>                                     |              |              |                     |                        |
| Residential  | 31           | 33           | (2)                 | (6.1%)                 |
| Commercial   | 10           | 11           | (1)                 | (5.7%)                 |
| Industrial   | 1            | 1            |                     | (17.2%)                |
| Public Authorities   | 3            | 3            |                     | (6.8%)                 |
| <b>Total Gas Retail Sales</b>                                | <b>45</b>    | <b>48</b>    | <b>(3)</b>          | <b>(6.3%)</b>          |
| Negotiated Sales Program (NSP)                               | 7            | 7            |                     | (2.1%)                 |
| <b>Total Gas Sales</b>                                       | <b>52</b>    | <b>55</b>    | <b>(3)</b>          | <b>(5.7%)</b>          |
| -Millions of Dollars-  |              |              |                     |                        |
| <b>Retail Margin Revenues:</b>                               |              |              |                     |                        |
| Residential  | \$ 14        | \$ 14        | \$                  | (3.9%)                 |
| Commercial   | 3            | 4            | (1)                 | (5.1%)                 |
| Industrial   |              |              |                     | (11.9%)                |
| Public Authorities   | 1            | 1            |                     | (7.4%)                 |
| <b>Total Retail Margin Revenues (Non-GAAP)<sup>(2)</sup></b> | <b>18</b>    | <b>19</b>    | <b>(1)</b>          | <b>(4.3%)</b>          |
| Transport and NSP  | 4            | 5            | (1)                 | (19.5%)                |
| Retail Fuel Revenues   | 29           | 34           | (5)                 | (14.8%)                |
| <b>Total Gas Revenues (GAAP)</b>                             | <b>\$ 51</b> | <b>\$ 58</b> | <b>\$ (7)</b>       | <b>(11.9%)</b>         |
| <b>Weather Data:</b>   |              |              |                     |                        |
| <b>Heating Degree Days</b>                                   |              |              |                     |                        |
| Three Months Ended March 31,                                 | 11,471       | 12,198       | (727)               | (6.0%)                 |
| 10-Year Average  | 11,890       | 11,950       | NM                  | NM                     |

<sup>(1)</sup> Percent change calculated on unrounded data and may not correspond exactly to data shown in table.

<sup>(2)</sup> Retail Margin Revenues, a non-GAAP financial measure, should not be considered as an alternative to Total Retail Sales, which is determined in accordance with GAAP. Retail Margin Revenues excludes revenues collected from retail customers that are directly offset by expenses recorded in other line items. We believe the change in Retail Margin Revenues between periods provides useful information to investors because it demonstrates the underlying revenue trend and performance of our core utility business. Retail Margin Revenues represents the portion of retail operating revenues available to cover the non-fuel operating expenses of our core utility business.

Retail therm sales during the first quarter of 2012 decreased by 6.3%, due in part to a 6.0% decrease in Heating Degree Days compared with the first quarter of 2011. Correspondingly, retail margin revenues decreased by 4.3%, or \$1 million, compared with the first quarter of 2011.

UNS Gas supplies natural gas to some of its large transportation customers through an NSP. Approximately one half of the margin earned on these NSP sales is retained by UNS Gas, while the remainder benefits retail customers through a credit to the PGA mechanism which reduces the gas commodity price.

**FACTORS AFFECTING RESULTS OF OPERATIONS****Competition**



## Edgar Filing: TUCSON ELECTRIC POWER CO - Form 10-Q

New technological developments and the implementation of Gas Energy Efficiency Standards (Gas EE Standards) may reduce energy consumption by UNS Gas retail customers. Customers of UNS Gas also have the ability to switch from gas to an alternate energy source that could reduce their reliance on services provided by UNS Gas.

### **Rates**

#### 2011 UNS Gas Rate Filing

Due to increases in capital and operating costs, UNS Gas filed a general rate case with the ACC in April 2011 requesting higher Base Rates. In April 2012, the ACC approved a Base Rate increase of \$2.7 million as well as a mechanism to enable UNS Gas to recover lost fixed-cost revenues as a result of implementing the ACC's Gas EE Standards.

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The table below summarizes UNS Gas' initial request and the ACC order:

|  | <b>Initial Request by UNS Gas</b> | <b>ACC Order</b>     |
|--|-----------------------------------|----------------------|
| Original Cost Rate Base (as of 12/31/2010) | \$184 million                     | \$183 million        |
| Revenue Deficiency                         | \$5.6 million                     | \$2.7 million        |
| Cost of Equity                             | 10.5%                             | 9.75%                |
| Actual Capital Structure                   | 51% equity /49% debt              | 51% equity /49% debt |
| Weighted Average Cost of Capital           | 8.7%                              | 8.3%                 |

The new rates will be effective on May 1, 2012. The impact of the Base Rate increase on customers' bills will be offset by a temporary credit adjustment to the PGA. See *Purchased Gas Adjustor (PGA)*, below, for more information.

**Purchased Gas Adjustor (PGA)**

The PGA mechanism is intended to address the volatility of natural gas prices and allow UNS Gas to recover its actual commodity costs, including transportation, through a price adjustor. The difference between UNS Gas' actual monthly gas and transportation costs and the rolling 12-month average cost of gas and transportation is deferred and recovered or returned to customers through the PGA mechanism.

The PGA mechanism has two components, the PGA factor and the PGA surcharge or credit. The PGA factor is a mechanism that calculates the twelve-month rolling weighted average gas cost and automatically adjusts monthly, subject to limitations on how much the price per therm may change in a 12-month period. The annual cap on the maximum increase in the PGA factor is 15 cents per therm in a 12-month period.

At any time UNS Gas' PGA balancing account, called the PGA bank balance, is under-recovered, UNS Gas may request a PGA surcharge with the goal of collecting the amount deferred from customers over a period deemed appropriate by the ACC. When the PGA bank balance reaches an over-collected balance of \$10 million on a billed-to-customers basis, UNS Gas is required to make a filing with the ACC to determine how the over-collected balance should be returned to customers.

In February 2012, UNS Gas requested ACC authorization for a temporary 4.5 cent per therm credit adjustment to the PGA to return over-collected PGA costs to customers. At March 31, 2012, the PGA bank balance was over-collected by \$14 million on a billed-to-customers basis. In April 2012, the ACC approved the temporary PGA credit of 4.5 cents per therm which will be applied to customers' bills beginning on May 1, 2012, and continuing through April 2014. The credit adjustment is expected to return approximately \$10 million of over-collected PGA costs to customers.

**Electric Energy Efficiency Standards**

In August 2010, the ACC approved new Gas Utility Energy Efficiency Standards (Gas EE Standards) designed to require UNS Gas and other affected utilities to implement cost-effective DSM programs. In 2011, the Gas EE Standards targeted total retail therm savings equal to 0.5% of 2010 sales; UNS Gas estimates its total savings in 2011 were 0.2%. Targeted savings increase annually in subsequent years until they reach a cumulative annual reduction in retail therm sales of 6% by 2020.

The Gas EE Standards can be met by: new and existing DSM programs, renewable energy technology that displaces gas, and by a portion of energy efficient building codes. The Gas EE Standards provide for the recovery of costs incurred to implement DSM programs. UNS Gas' DSM programs and Retail Rates charged to customers for these programs are subject to ACC approval.

In April 2011, UNS Gas filed its 2011- 2012 EE implementation plan. In September 2011, UNS Gas filed updated information in support of its plan which included a request for waiver of the Gas EE Standards. In April 2012, UNS Gas filed a request to amend its plan to include its 2013 EE plan and for a modified waiver of the Gas EE Standards. We cannot predict when the ACC will rule on the EE plan or the subsequent requests.

**Table of Contents****Fair Value Measurements**

UNS Gas' income statement exposure to risk is mitigated as UNS Gas reports the change in fair value of energy contract derivatives as a regulatory asset or a regulatory liability rather than in the income statement. See Note 9.

**LIQUIDITY AND CAPITAL RESOURCES****Liquidity Outlook**

UNS Gas expects operating cash flows to fund all of its construction expenditures during 2012. However, if natural gas prices rise and UNS Gas is not allowed to recover its projected gas costs or PGA bank balance on a timely basis, UNS Gas may require additional funding to meet operating and capital requirements. Sources of funding future capital expenditures could include draws on the UNS Gas/UNS Electric Revolver, additional credit lines, the issuance of long-term debt, or capital contributions from UniSource Energy.

**Cash Flows and Capital Expenditures****Cash Flows**

The table below provides summary cash flow information for UNS Gas:

| <b>Three Months Ended March 31,</b> | <b>2012</b>           | <b>2011</b>  |
|-------------------------------------|-----------------------|--------------|
|                                     | -Millions of Dollars- |              |
| <b>Cash Provided By (Used In):</b>  |                       |              |
| Operating Activities                | \$ 15                 | \$ 15        |
| Investing Activities                | (3)                   | (2)          |
| Financing Activities                | (10)                  | (10)         |
| <b>Net Increase in Cash</b>         | <b>2</b>              | <b>3</b>     |
| Beginning Cash                      | 38                    | 29           |
| <b>Ending Cash</b>                  | <b>\$ 40</b>          | <b>\$ 32</b> |

**Capital Expenditures**

UNS Gas incurred capital expenditures of \$3 million in the first quarter of 2012. Total capital expenditures for 2012 are estimated to be \$11 million.

**UNS Gas/UNS Electric Revolver**

The UNS Gas/UNS Electric Revolver consists of a \$100 million unsecured revolving credit and revolving letter of credit facility. Either company can borrow up to a maximum of \$70 million as long as the combined amount borrowed does not exceed \$100 million. The UNS Gas/UNS Electric Revolver expires November 2016.

UNS Gas is only liable for UNS Gas' borrowings, and similarly, UNS Electric is only liable for UNS Electric's borrowings under the UNS Gas/UNS Electric Revolver. As of March 31, 2012, UNS Gas had no outstanding borrowings or letters of credit under the UNS Gas/UNS Electric Revolver.

The UNS Gas/UNS Electric Revolver restricts additional indebtedness, liens, and mergers. It also requires each borrower not to exceed a maximum leverage ratio. Each borrower may pay dividends so long as it maintains compliance with the agreement. As of March 31, 2012, UNS Gas and UNS Electric each were in compliance with the terms of the UNS Gas/UNS Electric Revolver.

**Interest Rate Risk**

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UNS Gas is subject to interest rate risk resulting from changes in interest rates on its borrowings under its revolving credit facility. The interest paid on revolving credit borrowings is variable. If LIBOR or other benchmark interest rates increase, UNS Gas may be required to pay higher rates of interest on borrowings under its revolving credit facility. See *Item 3. Quantitative and Qualitative Disclosures about Market Risk*, below.

**Table of Contents****Contractual Obligations**

There have been no significant changes in UNS Gas contractual obligations or other commercial commitments from those reported in our 2011 Annual Report on Form 10-K, other than the following obligations established in 2012:

UNS Gas entered into new commitments for fuel that will settle in April 2012 through March 2015. Certain of these contracts are at a fixed price per MMBtu and others are indexed to natural gas prices. Based on projected market prices as of March 31, 2012, UNS Gas estimated minimum payment obligation for these purchases is \$2 million in each of 2012, 2013, and 2014 and \$1 million in 2015.

**Dividends on Common Stock**

UNS Gas paid dividends to UniSource Energy, through UES, of \$10 million in February 2012, and in February 2011. UNS Gas ability to pay future dividends will depend on the cash needs for capital expenditures and various other factors.

The note purchase agreement for UNS Gas contains restrictions on dividends. UNS Gas may pay dividends so long as (a) no default or event of default exists and (b) it could incur additional debt under the debt incurrence test. As of March 31, 2012, UNS Gas was in compliance with the terms of its note purchase agreement.

**UNS ELECTRIC****RESULTS OF OPERATIONS**

UNS Electric purchased BMGS from UED for \$63 million on July 1, 2011. In accordance with this transfer between two UniSource Energy subsidiaries under common control, the first quarters of 2012 and 2011 both reflect the results of BMGS. The transaction had no impact on UniSource Energy's consolidated financial statements. See Note 3.

UNS Electric reported net income of \$3 million in the first quarter of 2012, compared with net income of \$4 million in the first quarter of 2011. Like TEP, UNS Electric's operations are generally seasonal in nature, with peak energy demand occurring in the summer months. The table below provides summary financial information for UNS Electric:

| <b>Three Months Ended March 31,</b>           | <b>2012</b>           | <b>2011</b> |
|---|-----------------------|-------------|
|   | -Millions of Dollars- |             |
| Retail Electric Revenues                      | \$ 39                 | \$ 44       |
| Wholesale Electric Revenues                   | 8                     | 7           |
| Other Revenues                                | 1                     |             |
| <br>  |                       |             |
| Total Operating Revenues                      | 48                    | 51          |
| Purchased Energy Expense                      | 22                    | 25          |
| Fuel Expense                                  | 1                     | 1           |
| Transmission Expense                          | 2                     | 3           |
| Increase (Decrease) to reflect PPFAC Recovery | 2                     | 3           |
| O&M   | 8                     | 7           |
| Depreciation and Amortization Expense         | 5                     | 4           |
| Taxes Other Than Income Taxes                 | 1                     | 1           |
| <br>  |                       |             |
| Total Other Operating Expenses                | 41                    | 44          |
| <br>  |                       |             |
| Operating Income                              | 7                     | 7           |
| Total Interest Expense                        | 2                     | 1           |
| Income Tax Expense                            | 2                     | 2           |
| <br>  |                       |             |
| <b>Net Income</b>                             | <b>\$ 3</b>           | <b>\$ 4</b> |



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The table below shows UNS Electric's kWh sales and revenues for the first quarters of 2012 and 2011:

| Three Months Ended March 31,                                 | 2012         | 2011         | Increase (Decrease)<br>Amount | Percent <sup>(1)</sup> |
|--|--------------|--------------|-------------------------------|------------------------|
| - Millions of kWh -  |              |              |                               |                        |
| <b>Electric Retail Sales:</b>                                |              |              |                               |                        |
| Residential  | 171          | 180          | (9)                           | (5.3%)                 |
| Commercial   | 131          | 131          |                               | NM                     |
| Industrial   | 53           | 52           | 1                             | 2.9%                   |
| Mining   | 28           | 59           | (31)                          | (53.0%)                |
| Public Authorities   |              |              |                               | (9.5%)                 |
| <b>Total Electric Retail Sales</b>                           | <b>383</b>   | <b>422</b>   | <b>(39)</b>                   | <b>(9.3%)</b>          |
| -Millions of Dollars-  |              |              |                               |                        |
| <b>Retail Margin Revenues:</b>                               |              |              |                               |                        |
| Residential  | \$ 7         | \$ 6         | \$ 1                          | 1.0%                   |
| Commercial   | 6            | 7            | (1)                           | (6.0%)                 |
| Industrial   | 2            | 2            |                               | 4.5%                   |
| Mining   | 2            | 2            |                               | 6.2%                   |
| Public Authorities   |              |              |                               | NM                     |
| <b>Total Retail Margin Revenues (Non-GAAP)<sup>(2)</sup></b> | <b>17</b>    | <b>17</b>    |                               | <b>(0.6%)</b>          |
| <b>Fuel and Purchased Power Revenues</b>                     | <b>19</b>    | <b>25</b>    | <b>(6)</b>                    | <b>(22.8%)</b>         |
| <b>RES &amp; DSM Revenues</b>                                | <b>3</b>     | <b>2</b>     | <b>1</b>                      | <b>NM</b>              |
| <b>Total Retail Revenues (GAAP)</b>                          | <b>\$ 39</b> | <b>\$ 44</b> | <b>\$ (5)</b>                 | <b>(10.1%)</b>         |
| <b>Weather Data:</b>   |              |              |                               |                        |
| <b>Cooling Degree Days</b>                                   |              |              |                               |                        |
| Three Months Ended March 31                                  | 3,144        | 3,522        | (378)                         | (10.7%)                |
| 10-Year Average  | 3,369        | 3,402        | NM                            | NM                     |

(1) Percent change calculated on unrounded data and may not correspond exactly to data shown in table.

(2) Retail Margin Revenues, a non-GAAP financial measure, should not be considered as an alternative to Total Retail Revenues, which is determined in accordance with GAAP. Retail Margin Revenues exclude revenues collected from retail customers that are directly offset by expenses recorded in other line items. We believe the change in Retail Margin Revenues between periods provides useful information to investors because it demonstrates the underlying revenue trend and performance of our core utility business. Retail Margin Revenues represents the portion of retail operating revenues available to cover the non-fuel operating expenses of our core utility business.

Total retail kWh sales in the first quarter of 2012 decreased by 9.3% compared with the same period last year. The decline in retail kWh sales is primarily due to one of UNS Electric's mining customers generating a portion of its own electricity needs. Retail margin revenues in the first quarter of 2012 were consistent with the first quarter of 2011. See *Factors Affecting Results of Operations, Mining Customer*, below.

**FACTORS AFFECTING RESULTS OF OPERATIONS****Competition**

New technological developments and the implementation of Electric EE Standards may reduce energy consumption by UNS Electric's retail customers. In addition, UNS Electric customers have the ability to install renewable energy technologies and conventional generation units that could reduce their reliance on UNS Electric's service. Self-generation by UNS Electric customers has not had a significant impact to date.

**Mining Customer**

UNS Electric's largest customer, a copper mine located near Kingman, Arizona, began generating a portion of its own electricity needs in 2011. In 2012, UNS Electric expects its mining kWh sales to decrease by approximately 50% compared with 2011. However, due to UNS Electric's Retail Rate structure, UNS Electric expects the margin revenues from this customer to be near the same level as 2011. In the first quarters of 2012 and 2011, UNS Electric's mining-related margin revenues were \$2 million.



**Table of Contents****Renewable Energy Standard and Tariff**

As part of the 2010 UNS Electric rate order, the ACC authorized UNS Electric to recover operating costs, depreciation, property taxes, and a return on its investment in company-owned solar projects through RES funds until these costs are reflected in its Base Rates. Under these terms, UNS Electric expects to invest \$5 million annually in 2012 through 2014 in solar photovoltaic projects. We estimate that each \$5 million investment would build approximately 1.25 MW of solar capacity.

**Interest Rates**

UNS Electric is subject to interest rate risk resulting from changes in interest rates on its borrowings under its revolving credit facility. The interest paid on revolving credit borrowings is variable. If LIBOR or other benchmark interest rates increase, UNS Electric may be required to pay higher rates of interest on borrowings under its revolving credit facility.

**Electric Energy Efficiency Standards**

In 2010, the ACC approved EE Standards. See *Tucson Electric Power, Factors Affecting Results of Operations, Electric Energy Efficiency Standards*, above for more information.

In January 2012, the ACC approved UNS Electric's 2012 EE implementation plan. UNS Electric's plan includes an annual performance incentive of less than \$1 million. In 2011, UNS Electric's programs saved energy equal to approximately 0.76% of its 2010 sales. In 2012, the EE Standards target total a cumulative kWh savings of 3% of 2011 sales.

**Fair Value Measurements**

UNS Electric's income statement exposure to risk is mitigated as UNS Electric reports the change in fair value of energy contract derivatives as a regulatory asset or a regulatory liability rather than in the income statement. See Note 9.

**LIQUIDITY AND CAPITAL RESOURCES****Liquidity Outlook**

UNS Electric expects operating cash flows to fund a portion of its construction expenditures during 2012. Additional sources of funding future capital expenditures could include draws on the UNS Gas/UNS Electric Revolver, additional credit lines, the issuance of long-term debt, or capital contributions from UniSource Energy.

**Cash Flows and Capital Expenditures****Cash Flows**

The table below provides summary cash flow information for UNS Electric:

| <b>Three Months Ended March 31,</b> | <b>2012</b>           | <b>2011</b>  |
|-------------------------------------|-----------------------|--------------|
|                                     | -Millions of Dollars- |              |
| <b>Cash Provided By (Used In):</b>  |                       |              |
| Operating Activities                | \$ 13                 | \$ 14        |
| Investing Activities                | (9)                   | (7)          |
| Financing Activities                |                       | (2)          |
| <b>Net Increase in Cash</b>         | <b>4</b>              | <b>5</b>     |
| Beginning Cash                      | 5                     | 11           |
| <b>Ending Cash</b>                  | <b>\$ 9</b>           | <b>\$ 16</b> |

Capital Expenditures

UNS Electric had capital expenditures of \$9 million in the first quarter of 2012 and estimates total capital expenditures in 2012 of \$37 million.

**Table of Contents****UNS Gas/UNS Electric Revolver**

See *UNS Gas, Liquidity and Capital Resources, UNS Gas/UNS Electric Revolver* above for a description of UNS Electric's unsecured revolving credit agreement.

UNS Electric expects to draw upon the UNS Gas/UNS Electric Revolver from time to time for seasonal working capital purposes, to fund a portion of its capital expenditures or to issue letters of credit to provide credit enhancement for its energy procurement and hedging activities. As of March 31, 2012, UNS Electric had no outstanding borrowings and \$4 million of letters of credit issued under the UNS Gas/UNS Electric Revolver.

**Contractual Obligations**

There have been no significant changes in UNS Electric's contractual obligations or other commercial commitments from those reported in our 2011 Annual Report on Form 10-K, other than the following obligations established in 2012:

UNS Electric entered into new forward purchase power commitments that will settle at fixed prices per MWh from January 2014 through December 2014. UNS Electric's minimum payment obligation for these purchases is \$8 million.

**Dividends on Common Stock**

As of March 31, 2012, UNS Electric has not paid dividends. UNS Electric's ability to pay dividends will depend on the cash needs for capital expenditures and various other factors.

The note purchase agreement for UNS Electric contains restrictions on dividends. UNS Electric may pay dividends so long as (a) no default or event of default exists and (b) it could incur additional debt under the debt incurrence test. As of March 31, 2012, UNS Electric was in compliance with the terms of its note purchase agreement, and the terms of the UNS Gas/UNS Electric Revolver.

**OTHER NON-REPORTABLE BUSINESS SEGMENTS****RESULTS OF OPERATIONS**

The table below summarizes the income (loss) for the other non-reportable segments:

| <b>Three Months Ended March 31,</b> | <b>2012</b>           | <b>2011</b>   |
|-------------------------------------|-----------------------|---------------|
|                                     | -Millions of Dollars- |               |
| Millennium                          | \$ 1                  | \$            |
| Other <sup>(1)</sup>                | (2)                   | (2)           |
| <b>Total Other</b>                  | <b>\$ (1)</b>         | <b>\$ (2)</b> |

<sup>(1)</sup> Includes parent company expenses, UED, and reconciling adjustments.

**Millennium**

Millennium recorded net income of \$1 million in the first quarter of 2012 compared with no net income or losses in the first quarter of 2011.

**UniSource Energy Parent Company**

UniSource Energy parent company expenses primarily include interest expense (net of tax) related to the UniSource Energy Convertible Senior Notes and the UniSource Credit Agreement.



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### **FACTORS AFFECTING RESULTS OF OPERATIONS**

#### **Millennium Investments**

At March 31, 2012, Millennium had assets of \$20 million including a \$15 million note receivable due June 2012 and a cash balance of \$5 million.

### **CRITICAL ACCOUNTING ESTIMATES**

There have been no significant changes in our accounting policies from those disclosed in our 2011 Form 10-K.

### **SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. UniSource Energy and TEP are including the following cautionary statements to make applicable and take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 for any forward-looking statements made by or for UniSource Energy or TEP in this Quarterly Report on Form 10-Q. Forward-looking statements include statements concerning plans, objectives, goals, strategies, future events or performance and underlying assumptions, and other statements that are not statements of historical facts. Forward-looking statements may be identified by the use of words such as anticipates, estimates, expects, intends, plans, predicts, projects, and similar expressions. From time to time, we may publish or otherwise make available forward-looking statements of this nature. All such forward-looking statements, whether written or oral, and whether made by or on behalf of UniSource Energy or TEP, are expressly qualified by these cautionary statements and any other cautionary statements which may accompany the forward-looking statements. In addition, UniSource Energy and TEP disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of this report.

Forward-looking statements involve risks and uncertainties, which could cause actual results or outcomes to differ materially from those expressed therein. We express our expectations, beliefs, and projections in good faith and believe them to have a reasonable basis. However, we make no assurances that management's expectations, beliefs or projections will be achieved or accomplished. We have identified the following important factors that could cause actual results to differ materially from those discussed in our forward-looking statements. These may be in addition to other factors and matters discussed in: *Part II, Item 1A. Risk Factors*; *Part I, Item 2. Management's Discussion and Analysis*; and other parts of this report. These factors include: state and federal regulatory and legislative decisions and actions; regional economic and market conditions which could affect customer growth and energy usage; weather variations affecting energy usage; the cost of debt and equity capital and access to capital markets; the performance of the stock market and changing interest rate environment, which affect the value of our pension and other postretirement benefit plan assets and the related contribution requirements and expense; unexpected increases in O&M expense; resolution of pending litigation matters; changes in accounting standards; changes in critical accounting estimates; the ongoing restructuring of the electric industry; changes to long-term contracts; the cost of fuel and power supplies; cyber attacks or challenges to our information security; and the performance of TEP's generating plants.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

UniSource Energy's and TEP's primary market risks include fluctuations in interest rates, commodity prices and volumes, and counterparty credit. Fluctuations in interest rates can affect earnings and cash flows. We enter into interest rate swaps and financing transactions to manage changes in interest rates. Fluctuations in commodity prices and volumes and counterparty credit losses may temporarily affect cash flows, but are not expected to affect earnings due to expected recovery through regulatory mechanisms.

There have been no additional risks and no material changes to market risks disclosed in *Part II, Item 7A* in UniSource Energy's and TEP's Annual Report on Form 10-K for the year ended December 31, 2011, other than the following:

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**Commodity Price Risk TEP**

See *Item 2. Management's Discussion and Analysis, Tucson Electric Power, Factors Affecting Results of Operations, Long-Term Wholesale Sales, Salt River Project.*

**ITEM 4. CONTROLS AND PROCEDURES**

UniSource Energy's and TEP's Chief Executive Officer and Chief Financial Officer supervised and participated in UniSource Energy's and TEP's evaluation of their disclosure controls and procedures as such term is defined under Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act), as of the end of the period covered by this report. Disclosure controls and procedures are controls and procedures designed to ensure that information required to be disclosed in UniSource Energy's and TEP's periodic reports filed or submitted under the Exchange Act, is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. These disclosure controls and procedures are also designed to ensure that information required to be disclosed by UniSource Energy and TEP in the reports that they file or submit under the Exchange Act is accumulated and communicated to management, including the principal executive and principal financial officers, or person performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based upon the evaluation performed, UniSource Energy's and TEP's Chief Executive Officer and Chief Financial Officer concluded that UniSource Energy's and TEP's disclosure controls and procedures are effective.

While UniSource Energy and TEP continually strive to improve their disclosure controls and procedures to enhance the quality of their financial reporting, there has been no change in UniSource Energy's or TEP's internal control over financial reporting during the first quarter of 2012 that has materially affected, or is reasonably likely to materially affect, UniSource Energy's or TEP's internal control over financial reporting.

**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

See the legal proceedings described in *Item 3. Legal Proceedings* in our 2011 Annual Report on Form 10-K and in Note 6 and in *Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations*, which descriptions in Note 6 and Item 2 are incorporated herein by reference.

**ITEM 1A. RISK FACTORS**

The business and financial results of UniSource Energy and TEP are subject to numerous risks and uncertainties. There are no significant changes to the risks and uncertainties reported in our 2011 Annual Report on Form 10-K, other than the addition of operational risk factors for our gas operations described below:

**The nature of our gas operations presents inherent risks of loss that could adversely affect our results of operations.**

UNSGas operations are subject to inherent hazards and risks such as gas leaks, fires, natural disasters, catastrophic accidents, explosions, pipeline ruptures, and other hazards and risks that may cause unforeseen interruptions, personal injury, or property damage. Additionally, our facilities, machinery, and equipment, including our pipelines, are subject to third party damage from construction activities, vandalism, or acts of terrorism. Such incidents could result in severe business disruptions, significant decreases in revenues, and/or significant additional costs to us. Any such incident could have an adverse effect on our financial condition, earnings, and cash flows. In addition, any of these or similar events could cause environmental pollution, personal injury or death claims, damage to our properties or the properties of others, or loss of revenue by us or others.

**Table of Contents****ITEM 2. UNREGISTERED SALE OF EQUITY SECURITIES AND USE OF PROCEEDS**

See *Part I, Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations, UniSource Energy Consolidated, Liquidity and Capital Resources, Convertible Senior Notes.*

**ITEM 5. OTHER INFORMATION****COMPREHENSIVE INCOME**

The Financial Accounting Standards Board issued authoritative guidance that eliminated the option to report other comprehensive income in the statement of changes in equity. Rather, an entity must elect to present items of net income and other comprehensive income in one continuous statement or in two separate but consecutive statements. Effective in the first quarter of 2012, we elected to include separate statements of comprehensive income (loss) with our financial statements.

UniSource Energy's and TEP's comprehensive income for the previous three years are presented below:

|  | <b>UniSource Energy</b>         |                   |                   |
|--|---------------------------------|-------------------|-------------------|
|  | <b>Years Ended December 31,</b> |                   |                   |
|  | <b>2011</b>                     | <b>2010</b>       | <b>2009</b>       |
|  | -Thousands of Dollars-          |                   |                   |
| <b>Comprehensive Income</b>  |                                 |                   |                   |
| Net Income   | \$ 109,975                      | \$ 112,984        | \$ 105,901        |
| <b>Other Comprehensive Income (Loss)</b>   |                                 |                   |                   |
| Unrealized Gain (Loss) on Cash Flow Hedges, net of \$2,376; \$4,216; and (\$33) income taxes                                 | (3,626)                         | (6,431)           | 51                |
| Reclassification of Realized Losses on Cash Flow Hedges to Net Income, net of (\$1,412); (\$2,140); and (\$690) income taxes | 2,153                           | 3,264             | 1,053             |
| Supplemental Executive Retirement Plan (SERP) Benefit Adjustments, net of (\$804); \$523; and \$33 income taxes              | 1,158                           | (800)             | (51)              |
| <b>Total Other Comprehensive Income (Loss), Net of Income Taxes</b>  | <b>(315)</b>                    | <b>(3,967)</b>    | <b>1,053</b>      |
| <b>Total Comprehensive Income</b>  | <b>\$ 109,660</b>               | <b>\$ 109,017</b> | <b>\$ 106,954</b> |

|  | <b>TEP</b>                      |                |              |
|--|---------------------------------|----------------|--------------|
|  | <b>Years Ended December 31,</b> |                |              |
|  | <b>2011</b>                     | <b>2010</b>    | <b>2009</b>  |
|  | -Thousands of Dollars-          |                |              |
| <b>Comprehensive Income</b>  |                                 |                |              |
| Net Income   | \$ 85,334                       | \$ 108,260     | \$ 90,688    |
| <b>Other Comprehensive Income (Loss)</b>   |                                 |                |              |
| Unrealized Gain (Loss) on Cash Flow Hedges, net of \$2,331; \$4,216; and (\$33) income taxes                                 | (3,555)                         | (6,431)        | 51           |
| Reclassification of Realized Losses on Cash Flow Hedges to Net Income, net of (\$1,390); (\$2,140); and (\$690) income taxes | 2,122                           | 3,264          | 1,053        |
| Supplemental Executive Retirement Plan (SERP) Benefit Adjustments, net of (\$804); \$523; and \$33 income taxes              | 1,158                           | (800)          | (51)         |
| <b>Total Other Comprehensive Income (Loss), Net of Income Taxes</b>  | <b>(275)</b>                    | <b>(3,967)</b> | <b>1,053</b> |

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|                            |           |            |           |
|----------------------------|-----------|------------|-----------|
| Total Comprehensive Income | \$ 85,059 | \$ 104,293 | \$ 91,741 |
|----------------------------|-----------|------------|-----------|



**Table of Contents****RATIO OF EARNINGS TO FIXED CHARGES**

The following table reflects the ratio of earnings to fixed charges for UniSource Energy and TEP:

|                  | <b>Three Months<br/>Ended<br/>March 31, 2012</b> | <b>Twelve Months<br/>Ended<br/>March 31, 2012</b> |
|------------------|--|---|
| UniSource Energy | 1.338  | 2.368   |
| TEP              | N/M  | 2.308   |

For purposes of this computation, earnings are defined as pre-tax earnings plus interest expense and amortization of debt discount and expense related to indebtedness. Fixed charges are interest expense, including amortization of debt discount and expense on indebtedness.

For the three months ended March 31, 2012, TEP's Ratio of Earnings to Fixed Charges was less than 1.00. TEP's earnings (as defined above), were deficient by \$3 million. The deficiency had no impact on TEP's debt covenants.

**ENVIRONMENTAL MATTERS****Clean Air Act Requirements**

TEP generating facilities are subject to Environmental Protection Agency (EPA) limits on the amount of sulfur dioxide (SO<sub>2</sub>), nitrogen oxide (NO<sub>x</sub>), and other emissions released into the atmosphere. TEP may incur additional costs to comply with future changes in federal and state environmental laws, regulations, and permit requirements at its generating facilities. Compliance with these changes may reduce operating efficiency.

TEP has sufficient Emission Allowances to comply with acid rain SO<sub>2</sub> regulations.

**EPA Information Request**

TEP submitted its response to the request received in 2010 from the EPA under Section 114 of the Clean Air Act for information regarding projects and operations at the H. Wilson Sundt Generating Station (Sundt). TEP owns and operates all four units at Sundt. Units 1, 2, and 3 can be operated on either natural gas or diesel oil. Unit 4 can be operated on either natural gas or coal.

The EPA uses information obtained from such requests to determine if additional action is necessary. TEP can neither predict whether the EPA will take further action at Sundt nor project the impact of any such action.

**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 2009, the EPA entered into a consent order through which it agreed to develop rules establishing standards for the control of emissions of mercury and other hazardous air pollutants from electric generating units. The EPA issued the final rule in December 2011.

**Navajo**

Based on the EPA's final standards, mercury and particulate emission control equipment may be required at Navajo by 2015. TEP's share of the estimated capital cost of this equipment for Navajo is less than \$1 million for mercury control and approximately \$43 million if the installation of baghouses to control particulates is necessary. TEP expects its share of the annual operating costs for mercury control and baghouses to be less than \$1 million each.

**Springerville**

Based on the EPA's final standards, mercury emission control equipment may be required at Springerville by 2015. The estimated capital cost of this equipment for Springerville Units 1 and 2 is approximately \$5 million. The annual operating cost associated with the mercury emission

control equipment is expected to be approximately \$3 million.

San Juan

Current emission controls at San Juan are expected to be adequate to achieve compliance with the EPA's final standards.

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### **Sundt**

TEP does not anticipate the final EPA rule will have a material impact on TEP's capital expenditures related to Sundt.

### **Four Corners**

Based on the EPA's final standards, mercury emission control equipment may be required at Four Corners by 2015. The estimated capital cost of this equipment is less than \$1 million. The annual operating cost associated with the mercury emission control equipment is expected to be less than \$1 million.

### **Climate Change**

In 2007, the Supreme Court ruled in *Commonwealth of Massachusetts, et al. v. EPA* that Carbon Dioxide and other greenhouse gases (GHGs) are air pollutants under the Clean Air Act. In 2009, the EPA issued a final Endangerment Finding stating that GHGs endanger public health and welfare. The EPA issued final GHG regulations for new motor vehicles in 2010, triggering GHG permitting requirements for power plants under the Clean Air Act. As of January 2011, air quality permits for new sources and modifications of existing sources must include an analysis for GHG controls. In the near term, based on our current construction plans, we do not expect the new permitting requirements to impact TEP or UNS Electric.

In March 2012, the EPA released its proposed new source performance standard for GHGs. TEP does not anticipate any material impact on its existing facilities.

While the debate over the direction of domestic climate policy continues on the national level, several states have developed state-specific policies or regional initiatives to reduce GHG emissions. In 2007, the governors of several western states, including the then-governor of Arizona, signed the Western Regional Climate Action Initiative (the Western Climate Initiative) which directed their respective states to develop a regional target for reducing GHGs. The states in the Western Climate Initiative announced a target of reducing GHG emissions by 15% below 2005 levels by 2020. In 2008, the Western Climate Initiative participants submitted their design recommendation for the Western Climate Initiative cap-and-trade program for GHG emissions with an implementation date set for 2012. In November 2011, the State of Arizona formally withdrew from the Western Climate Initiative.

In 2010, New Mexico adopted regulations limiting GHG emissions from power plants and providing for participation in the Western Climate Initiative. Several parties filed petitions to repeal those regulations and the New Mexico Environmental Improvement Board held hearings on the repeal petitions in November and December 2011. In the first quarter of 2012, the New Mexico Environmental Improvement Board repealed all of the 2010 GHG regulations.

Based on the competing proposals to regulate GHG emissions by federal, state, and local regulatory and legislative bodies and uncertainty in the regulatory and legislative processes, the scope of such requirements and initiatives and their effect on our operations cannot be determined at this time.

### **Regional Haze Rules**

The EPA's regional haze rules require emission controls known as Best Available Retrofit Technology (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 and to submit a state implementation plan to the EPA for approval. Navajo and Four Corners are located on the Navajo Indian Reservation and therefore are not subject to state regulatory jurisdictions. The EPA is the lead regulatory agency for these plants in terms of regional haze planning.

Compliance with the EPA's BART determinations, coupled with the financial impact of future climate change legislation, other environmental regulations and other business considerations, could jeopardize the economic viability of the San Juan, Four Corners, and Navajo plants or the ability of individual participants to meet their obligations and maintain participation in these plants. TEP cannot predict the ultimate outcome of these matters.

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### **Navajo**

The EPA is expected to issue a proposed rule establishing the BART for Navajo following the consideration of a report by the National Renewable Energy Laboratory in partnership with the Department of the Interior and the Department of Energy. The report addresses potential energy, environmental, and economic issues related to compliance with the regional haze rule. The report was submitted to the EPA in January 2012. A final BART rule is expected later in 2012. If the EPA determines that selective catalytic reduction (SCR) is required at Navajo, the capital cost impact to TEP is estimated to be \$42 million. In addition, the installation of SCR at Navajo could increase the plant's particulate emissions, necessitating the installation of baghouses. If baghouses are required, TEP's estimated share of the capital expenditure for the required baghouses would be approximately \$43 million. The cost of required pollution controls will not be known until final determinations are made by the regulatory agencies. TEP anticipates that if the EPA finalizes a BART rule for Navajo that requires SCR, the owners would have five years to achieve compliance.

### **San Juan**

In August 2011, the EPA issued a Federal Implementation Plan (FIP) establishing new emission limits for air pollutants at San Juan. The FIP requires the installation of SCR technology with sorbent injection on all four units within five years in order to reduce NOx and control sulfuric acid emissions. San Juan is able to meet the FIP's SO<sub>2</sub> limit with current emissions control equipment. Based on two cost analyses commissioned by PNM, TEP's share of the cost to install SCR with sorbent injection is estimated to be between \$180 and \$200 million.

In 2011, PNM filed a petition for review of, and a motion to stay the implementation of the FIP with the Tenth Circuit U.S. Court of Appeals (Circuit Court). In addition, PNM filed a request for reconsideration of the rule with the EPA, and a request to stay the effectiveness of the rule pending the EPA's reconsideration, and the review by the Circuit Court. The State of New Mexico filed similar motions with the Circuit Court and EPA. In March 2012, the Circuit Court denied the motion for stay.

Several environmental groups were granted permission to join in opposition to PNM's petition to review in the Circuit Court. In addition, WildEarth Guardians filed a separate appeal against the EPA challenging the five-year, rather than three-year, implementation schedule. PNM was granted permission to join in opposition to that appeal.

### **Four Corners**

In February 2011, the EPA supplemented the proposed FIP for the BART determination at Four Corners that it had originally issued in 2010. If approved, the revised plan would require the installation of SCR on Units 4 and 5 by 2018. TEP's estimated share of the capital costs to install SCR is approximately \$35 million.

### **Coal Combustion Residuals**

In 2010, the EPA published its proposed regulations governing the handling and disposal of coal ash and other Coal Combustion Residuals (CCRs). The EPA has proposed regulating CCRs as either non-hazardous solid waste or hazardous waste. The hazardous waste alternative would require additional capital investments and operational costs associated with storage and handling at plants and transportation to the disposal locations. Both the hazardous waste and non-hazardous solid waste alternatives would require liners for new ash landfills or expansions to existing ash landfills. The rules will apply to CCRs produced by all of TEP's coal-fired generating assets. San Juan may also be subject to separate regulations being drafted by the Office of Surface Mining Reclamation and Enforcement because it disposes of CCRs in surface mine pits.

The EPA has not yet indicated a preference for an alternative. Each option would allow CCRs to be beneficially reused or recycled as components of other products. The EPA has indicated that it will issue a final rule by the end of 2012. The financial impact of this rulemaking to TEP, if any, cannot be determined at this time.

## **ITEM 6. EXHIBITS**

See Exhibit Index.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, each registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized. The signature for each undersigned company shall be deemed to relate only to matters having reference to such company or its subsidiaries.

UNISOURCE ENERGY CORPORATION

(Registrant)

Date: April 30, 2012

/s/ Kevin P. Larson  
Kevin P. Larson  
Senior Vice President and Principal

Financial Officer

TUCSON ELECTRIC POWER COMPANY

(Registrant)

Date: April 30, 2012

/s/ Kevin P. Larson  
Kevin P. Larson  
Senior Vice President and Principal

Financial Officer

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**EXHIBIT INDEX**

- \*4(a) Indenture of Trust, dated as of March 1, 2012, between The Industrial Development Authority of the County of Apache and U.S. Bank Trust National Association, authorizing Pollution Control Revenue Bonds, 2012 Series A (Tucson Electric Power Company Project) (Form 8-K dated March 21, 2012 Exhibit 4(a)).
  
- \*4(b) Loan Agreement, dated as of March 1, 2012, between The Industrial Development Authority of the County of Apache and TEP, relating to Pollution Control Revenue Bonds, 2012 Series A (Tucson Electric Power Company Project) (Form 8-K dated March 21, 2012 Exhibit 4(b)).
  
- 12(a) Computation of Ratio of Earnings to Fixed Charges UniSource Energy.
  
- 12(b) Computation of Ratio of Earnings to Fixed Charges TEP.
  
- 15(a) Letter regarding unaudited interim financial information UniSource Energy.
  
- 15(b) Letter regarding unaudited interim financial information TEP.
  
- 31(a) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act UniSource Energy, by Paul J. Bonavia.
  
- 31(b) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act UniSource Energy, by Kevin P. Larson.
  
- 31(c) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act TEP, by Paul J. Bonavia.
  
- 31(d) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act TEP, by Kevin P. Larson.
  
- \*\*32 Statements of Corporate Officers (pursuant to Section 906 of the Sarbanes-Oxley Act of 2002).
  
- \*\*101 The following materials from UniSource Energy Corporation's and Tucson Electric Power Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2012, formatted in XBRL (Extensible Business Reporting Language):
  - (a) UniSource Energy Corporation's and Tucson Electric Power Company's (i) Condensed Consolidated Statements of Income (Loss), (ii) Condensed Consolidated Statements of Comprehensive Income (Loss) (iii) Condensed Consolidated Statements of Cash Flows, (iv) Condensed Consolidated Balance Sheets, (v) Condensed Consolidated Statement of Changes in Stockholders' Equity; and
  
  - (b) Notes to Condensed Consolidated Financial Statements.

\* Previously filed as indicated and incorporated herein by reference.

\*\* Not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.