

# UNISOURCE ENERGY CORP

## FORM 10-K (Annual Report)

Filed 02/26/10 for the Period Ending 12/31/09

Address	ONE SOUTH CHURCH AVENUE SUITE 100 TUCSON, AZ 85701
Telephone	520-571-4000
CIK	0000941138
Symbol	UNS
SIC Code	4911 - Electric Services
Industry	Electric Utilities
Sector	Utilities
Fiscal Year	12/31



**UNITED STATES  
 SECURITIES AND EXCHANGE COMMISSION  
 Washington, D.C. 20549**

**FORM 10-K**

(Mark One)

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

For the fiscal year ended December 31, 2009

OR

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

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

Commission File Number	Registrant; State of Incorporation; Address; and Telephone Number	IRS Employer Identification Number
1-13739	<b>UNISOURCE ENERGY CORPORATION</b> (An Arizona Corporation) One South Church Avenue, Suite 100 Tucson, AZ 85701 (520) 571-4000	86-0786732
1-5924	<b>TUCSON ELECTRIC POWER COMPANY</b> (An Arizona Corporation) One South Church Avenue, Suite 100 Tucson, AZ 85701 (520) 571-4000	86-0062700

**Securities registered pursuant to Section 12(b) of the Exchange Act:**

Registrant	Title of Each Class	Name of Each Exchange on Which Registered
UniSource Energy Corporation	Common Stock, no par value	New York Stock Exchange

**Securities registered pursuant to Section 12(g) of the Exchange Act: None**

Indicate by check mark if the registrant is a well known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933.

UniSource Energy Corporation	Yes <input checked="" type="checkbox"/>	No <input type="checkbox"/>
Tucson Electric Power Company	Yes <input type="checkbox"/>	No <input checked="" type="checkbox"/>

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934 (Exchange Act).

UniSource Energy Corporation	Yes <input type="checkbox"/>	No <input checked="" type="checkbox"/>
Tucson Electric Power Company	Yes <input checked="" type="checkbox"/>	No <input type="checkbox"/>

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 <input checked="" type="checkbox"/>	No <input type="checkbox"/>
Tucson Electric Power Company (1)	Yes <input type="checkbox"/>	No <input checked="" type="checkbox"/>

(1) As indicated above, Tucson Electric Power Company is not required to file reports under the Exchange Act. However, Tucson Electric Power Company has filed all Exchange Act reports for the preceding 12 months.

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

UniSource Energy Corporation	Yes <input type="checkbox"/>	No <input type="checkbox"/>
Tucson Electric Power Company	Yes <input type="checkbox"/>	No <input type="checkbox"/>

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of each registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 definition of "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

UniSource Energy Corporation	Large Accelerated Filer <input checked="" type="checkbox"/>	Accelerated Filer <input type="checkbox"/>	Non-accelerated filer <input type="checkbox"/>	Smaller Reporting Company <input type="checkbox"/>
Tucson Electric Power Company	Large Accelerated Filer <input type="checkbox"/>	Accelerated Filer <input type="checkbox"/>	Non-accelerated filer <input checked="" type="checkbox"/>	Smaller Reporting Company <input type="checkbox"/>

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 <input type="checkbox"/>	No <input checked="" type="checkbox"/>
Tucson Electric Power Company	Yes <input type="checkbox"/>	No <input checked="" type="checkbox"/>

The aggregate market value of UniSource Energy Corporation voting Common Stock held by non-affiliates of the registrant was \$933,280,480 based on the last reported sale price thereof on the consolidated tape on June 30, 2009.

At February 23, 2010, 35,941,414 shares of UniSource Energy Corporation Common Stock, no par value (the only class of Common Stock), were outstanding.

At February 23, 2010, 32,139,434 shares of Tucson Electric Power Company's common stock, no par value, were outstanding, all of which were held by UniSource Energy Corporation.

**Tucson Electric Power Company meets the conditions set forth in General Instructions (I)(1)(a) and (b) on Form 10-K and is therefore filing this report with the reduced disclosure format.**

Documents incorporated by reference: Specified portions of UniSource Energy Corporation's Proxy Statement relating to the 2010 Annual Meeting of Shareholders are incorporated by reference into Part III.

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**DEFINITIONS**

The abbreviations and acronyms used in the 2009 Form 10-K 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.
1999 Settlement Agreement	TEP's Settlement Agreement approved by the ACC in November 1999 that provided for electric retail competition and transition asset recovery.
2008 TEP Rate Order	A rate order issued by the ACC resulting in a new retail rate structure for TEP, effective December 1, 2008.
ACC	Arizona Corporation Commission.
ALJ	Administrative Law Judge.
AMT	Alternative Minimum Tax.
APS	Arizona Public Service Company.
BART	Best Available Retrofit Technology.
BMGS	Black Mountain Generating Station.
Btu	British thermal unit(s).
CCB	Coal combustion byproducts.
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 MWs.
Citizens	Citizens Communications Company.
Collateral Trust Bonds	Bonds issued under the Indenture of Trust, dated as of August 1, 1998, of TEP to The Bank of New York, successor trustee.
Common Stock	UniSource Energy's common stock, without par value.
Company or UniSource Energy	UniSource Energy Corporation.
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.
Emission Allowance(s)	An allowance issued by the Environmental Protection Agency which permits emission of one ton of sulfur dioxide or one ton of nitrogen oxide. These allowances can be bought and sold.
Energy	The amount of power produced over a given period of time; measured in MWh.
EPA	The Environmental Protection Agency.
EL Paso	El Paso Electric Company.
EPNG	El Paso Natural Gas Company.
ESP	Energy Service Provider.
Express Line	A dedicated 345-kV transmission line from Springerville Unit 2 to TEP's retail service area.
FERC	Federal Energy Regulatory Commission.
Fixed CTC	Competition Transition Charge of approximately \$0.009 per kWh that was included in TEP's retail rate for the purpose of recovering TEP's TRA. Approximately \$58 million will be credited to customers through the PPFAC.
Four Corners	Four Corners Generating Station.
GHG	Greenhouse gases.
Haddington	Haddington Energy Partners II, LP, a limited partnership that funds energy-related investments.
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.
IDBs	Industrial development revenue or pollution control revenue bonds.
IRS	Internal Revenue Service.
kWh	Kilowatt-hour(s).
kV	Kilovolt(s).
LIBOR	London Interbank Offered Rate.

Luna	Luna Energy Facility.
Mark-to-Market Adjustments	Forward energy sales and purchase contracts that are considered to be derivatives are adjusted monthly by recording unrealized gains and losses to reflect the market prices at the end of each month.
Millennium	Millennium Energy Holdings, Inc., a wholly-owned subsidiary of UniSource Energy.
MMBtu	Million British Thermal Units.
Mortgage Bonds	Bonds issued under the 1992 Mortgage.
MW	Megawatt(s).
MWh	Megawatt-hour(s).
Navajo	Navajo Generating Station.
NERC	North American Electric Reliability Corporation.
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.
Pima Authority	The Industrial Development Authority of the County of Pima.
PNM	Public Service Company of New Mexico.
PNMR	PNM Resources.
PPA	Purchased Power Agreement.
PPFAC	Purchased Power and Fuel Adjustment Clause.
PWMT	Pinnacle West Marketing and Trading.
REST	Renewable Energy Standard and Tariff rules approved by the ACC in October 2006.
Repurchased Bonds	\$221 million of fixed-rate tax-exempt bonds that TEP purchased from bondholders on May 11, 2005.
Rules	Retail Electric Competition Rules.
Sabinas	Carboelectrica Sabinas, S. de R.L. de C.V., a Mexican limited liability company. Prior to June 2009, Millennium owned 50% of Sabinas.
San Carlos	San Carlos Resources Inc., a wholly-owned subsidiary of TEP.
San Juan	San Juan Generating Station.
SO <sub>2</sub>	Sulfur dioxide.
Springerville	Springerville Generating Station.
Springerville Coal Handling Facilities Leases	Leveraged lease arrangements relating to the coal handling facilities serving Springerville.
Springerville Common Facilities	Facilities at Springerville used in common with Springerville Unit 1 and Springerville Unit 2.
Springerville Common Facilities Leases	Leveraged lease arrangements relating to an undivided one-half interest in certain Springerville Common Facilities.
Springerville Unit 1	Unit 1 of the Springerville Generating Station.
Springerville Unit 1 Leases	Leveraged lease arrangement relating to Springerville Unit 1 and an undivided one-half interest in certain Springerville Common Facilities.
Springerville Unit 2	Unit 2 of the Springerville Generating Station.
Springerville Unit 3	Unit 3 of the Springerville Generating Station.
Springerville Unit 4	Unit 4 of the Springerville Generating Station.
SRP	Salt River Project Agricultural Improvement and Power District.
Sundt	H. Wilson Sundt Generating Station (formerly known as the Irvington Generating Station).
Sundt Lease	The leveraged lease arrangement relating to Sundt Unit 4.
Sundt Unit 4	Unit 4 of the H. Wilson Sundt Generating Station.
SWG	Southwest Gas Corporation.
TEP	Tucson Electric Power Company, the principal subsidiary of UniSource Energy.
TEP Credit Agreement	Amended and Restated Credit Agreement between TEP and a syndicate of Banks, dated as of August 11, 2006.
TEP Letter of Credit Facility	Letter of credit facility between TEP and a syndicate of Banks, dated as of April 30, 2008.
TEP Revolving Credit Facility	Revolving credit facility under the TEP Credit Agreement.



Therm	A unit of heating value equivalent to 100,000 British thermal units (Btu).
TRA	Transition Recovery Asset, a \$450 million regulatory asset established in TEP's 1999 Settlement Agreement that was fully recovered in May 2008.
Tri-State	Tri-State Generation and Transmission Association.
UED	UniSource Energy Development Company, a wholly-owned subsidiary of UniSource Energy, which engages in developing generation resources and other project development services and related activities.
UES	UniSource Energy Services, Inc., an intermediate holding company established to own the operating companies (UNS Gas and UNS Electric) which acquired the Citizens Arizona gas and electric utility assets in 2003.
UniSource Energy Credit Agreement	Amended and Restated Credit Agreement between UniSource Energy and a syndicate of banks, dated as of August 11, 2006.
UniSource Energy	UniSource Energy Corporation.
UNS Electric	UNS Electric, Inc., a wholly-owned subsidiary of UES, which acquired the Citizens Arizona electric utility assets in 2003.
UNS Gas	UNS Gas, Inc., a wholly-owned subsidiary of UES, which acquired the Citizens Arizona gas utility assets in 2003.
UNS Gas/UNS Electric Revolver	Revolving credit facility under the Amended and Restated Credit Agreement among UNS Gas and UNS Electric as borrowers, and UES as guarantor, and a syndicate of banks, dated as of August 11, 2006.
Valencia	Valencia power plant owned by UNS Electric.
WAPA	Western Area Power Administration.

**PART I**

This combined Form 10-K is being filed separately by UniSource Energy Corporation and Tucson Electric Power Company (collectively, the Registrants). Information contained herein relating to any individual registrant is filed by such registrant on its own behalf. TEP does not make any representation as to information relating to any other subsidiary of UniSource Energy.

This Annual Report on Form 10-K contains forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. You should read forward-looking statements together with the cautionary statements and important factors included in this Form 10-K. (See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, Safe Harbor for Forward-Looking Statements*). Forward-looking statements include statements concerning plans, objectives, goals, strategies, future events or performance and underlying assumptions. Forward-looking statements 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. 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. 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.

**ITEM 1. — BUSINESS****OVERVIEW OF CONSOLIDATED BUSINESS**

UniSource Energy is a holding company that has no significant operations of its own. Operations are conducted by UniSource Energy's subsidiaries, each of which is a separate legal entity with its own assets and liabilities. UniSource Energy owns the outstanding common stock of TEP, UniSource Energy Services, Inc. (UES), UniSource Energy Development Company (UED) and Millennium Energy Holdings, Inc. (Millennium). We conduct our business in three primary business segments — TEP, UNS Gas and UNS Electric.

TEP, an electric utility, provides electric service to the community of Tucson, Arizona. UES, through its two operating subsidiaries, UNS Gas, Inc. (UNS Gas) and UNS Electric, Inc. (UNS Electric), provides gas and electric service to 30 communities in Northern and Southern Arizona.

UED developed and owns the Black Mountain Generating Station (BMGS), a natural gas-fired combustion turbine in Northern Arizona that, through a power sales agreement, provides energy to UNS Electric.

Millennium has existing investments in unregulated businesses that represent 1% of UniSource Energy's total assets as of December 31, 2009; no new investments are planned in Millennium.

UniSource Energy was incorporated in the State of Arizona in 1995 and obtained regulatory approval to form a holding company in 1997. In 1998, TEP and UniSource Energy exchanged shares of stock resulting in TEP becoming a subsidiary of UniSource Energy.

**BUSINESS SEGMENT CONTRIBUTIONS**

The table below shows the contributions to our consolidated after-tax earnings by our three business segments.

	<u>2009</u>	<u>2008</u>	<u>2007</u>
	-Millions of Dollars-		
TEP	\$ 89	\$ 4	\$ 53
UNS Gas	7	9	4
UNS Electric	6	4	5
Other <sup>(1)</sup>	<u>2</u>	<u>(3)</u>	<u>(4)</u>
Consolidated Net Income	<u>\$ 104</u>	<u>\$ 14</u>	<u>\$ 58</u>

<sup>(1)</sup> Includes: UniSource Energy parent company expenses; income and losses from Millennium investments and UED and interest expense (net of tax) on the UniSource Energy Convertible Senior Notes and on the UniSource Energy Credit Agreement.

References in this report to “we” and “our” are to UniSource Energy and its subsidiaries, collectively.

**Rates and Regulation of Business Segments**

The Arizona Corporation Commission (ACC) regulates portions of TEP, UNS Gas and UNS Electric’s utility accounting practices and electricity rates. The ACC has authority over rates charged to retail customers, the issuance of securities, and transactions with affiliated parties. Our regulated utilities’ rates for retail electric and natural gas service are determined on a “cost of service” basis. Rates are designed to provide, after recovery of allowable operating expenses, an opportunity for us to earn a reasonable return on rate base. Rate base is generally determined by reference to the original cost and reconstruction (net of depreciation) of utility plant in service to the extent deemed used and useful, and to various adjustments for deferred taxes and other items plus a working capital component. Over time, additions to utility plant in service increase rate base and depreciation and retirement of utility plant reduce the rate base.

The Federal Energy Regulatory Commission (FERC) regulates the terms and prices of transmission services and wholesale electricity sales, wholesale transport and purchases of natural gas and portions of our accounting practices. TEP and UNS Electric have FERC tariffs to sell power at market based rates.

**TEP**

TEP was incorporated in the State of Arizona in 1963. TEP is the principal operating subsidiary of UniSource Energy. In 2009, TEP’s electric utility operations contributed 79% of UniSource Energy’s operating revenues and comprised 81% of its assets.

**SERVICE AREA AND CUSTOMERS**

TEP is a vertically integrated utility that provides regulated electric service to approximately 402,000 retail customers in Southeastern Arizona. TEP’s service territory consists of a 1,155 square mile area and includes a population of approximately 1 million in the greater Tucson metropolitan area in Pima County, as well as parts of Cochise County. TEP holds franchises to provide electric distribution service to customers in the Cities of Tucson and South Tucson. These franchises expire in 2026 and 2017, respectively. TEP also sells electricity to other utilities and power marketing entities in the Western U.S.

**Retail Customers**

TEP provides electric utility service to a diverse group of residential, commercial, industrial, and public sector customers. Major industries served include copper mining, cement manufacturing, defense, health care, education, military bases and other governmental entities. TEP’s retail sales are influenced by several factors, including seasonal weather patterns and overall economic climate.

The table below shows the percentage distribution of TEP's energy sales by major customer class over the last three years. The retail energy consumption by customer class through 2012 is expected to be similar to the historical distribution.

	2009	2008	2007
Residential	42%	41%	42%
Commercial	21%	21%	21%
Non-mining Industrial	23%	24%	24%
Mining	11%	11%	10%
Public Authority	3%	3%	3%

Two of TEP's largest retail customers are in the copper mining industry. TEP's kWh sales to mining customers depend on a variety of factors including changes in supply and demand in the world copper market and the economics of self-generation.

Local, regional, and national economic factors can impact the level of customer growth and the financial condition and operations of TEP's large commercial and industrial customers and as a result directly impact energy consumption. Economic conditions can also impact sales to residential and small commercial customers if employment and consumer spending levels change.

As a result of weak economic conditions during 2008 and 2009, retail customer growth and energy usage by retail customers at TEP were below the average levels experienced in prior years. In 2008 and 2009, TEP's average number of retail customers increased by less than 1% per year. This compares with average annual increases of 2% from 2003 to 2007.

TEP's total retail kWh sales decreased by 1.4% in 2008 compared with 2007. This was the first year-over-year decrease in TEP's retail kWh sales since 2002. In 2009, TEP's kWh sales once again declined by 1.4% over the prior year's levels. This compares with average annual increases in retail kWh sales of 4% from 2003 to 2007. We cannot predict if the customer growth rate or sales volumes will return to historic levels. However, we expect TEP's customer base to grow at a rate of less than 1% in 2010 and approximately 1% in 2011.

#### Energy Service Providers

In 2001, all of TEP's retail customers became eligible to choose an alternative energy service provider (ESP); however, none of TEP's retail customers are currently being serviced by an alternative ESP. See *Rates and Regulation*, below for more information regarding the status of retail competition in Arizona.

#### **Wholesale Business**

TEP's electric utility operations include the wholesale marketing of electricity to other utilities and power marketers. Wholesale sales transactions are made on both a firm and interruptible basis. A firm contract requires TEP to supply power on demand (except under limited emergency circumstances), while an interruptible contract allows TEP to stop supplying power under defined conditions. See *Purchases and Interconnections*, below.

Generally, TEP commits to future sales based on expected excess generating capability, forward prices and generation costs, using a diversified portfolio approach to provide a balance between long-term, mid-term and spot energy sales. When TEP expects to have excess generating capacity and energy (usually in the first, second and fourth calendar quarters), its wholesale sales consist primarily of two types of sales:

#### Long-term sales

Long-term wholesale sales contracts are for periods of more than one year. TEP typically uses its own generation to serve the requirements of its long-term wholesale customers. TEP currently has long-term contracts with three entities to sell firm capacity and energy:

- Salt River Project Agricultural Improvement and Power District (SRP), 100 MW, expires in May 2016. Under the current terms of the contract, TEP receives an annual demand charge of approximately \$22 million, while the cost of the energy sold is based on TEP's average generation cost. Beginning in June 2011, SRP will purchase 876 MWhs annually, TEP will not receive a demand charge and the price of energy will be based on a slight discount to the Dow Jones Palo Verde Electricity Price Indexes (Palo Verde Index).
- Navajo Tribal Utility Authority (NTUA) expires in December 2015. 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 MWh. Beginning in 2010, the price of 50% of the kWh sales from June to September will be based on the Palo Verde Index.

- Tohono O'odham Utility Authority, 2 MW, expires in 2014.

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Short-term sales

Under forward contracts, TEP commits to sell a specified amount of capacity or energy at a specified price over a given period of time, typically for one-month, three-month or one-year periods. Under short-term sales, TEP sells energy in the daily or hourly markets at fluctuating spot market prices and makes other non-firm energy sales. Beginning January 1, 2009, all revenues from short-term wholesale sales offset fuel and purchased power costs that are passed through to TEP retail customers. TEP uses short-term wholesale sales as part of its hedging strategy to reduce customer exposure to fluctuating power prices. See *Rates and Regulation*, below.

See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, Tucson Electric Power Company, Factors Affecting Results of Operations*, for additional discussion of TEP's wholesale marketing activities.

**GENERATING AND OTHER RESOURCES**

At December 31, 2009, TEP owned or leased 2,229 MW of net generating capability, as set forth in the following table:

Generating Source	Unit No.	Location	Date In Service	Fuel Type	Net Capability MW	Operating Agent	TEP's Share	
							%	MW
Springerville Station <sup>(1)</sup>	1	Springerville, AZ	1985	Coal	387	TEP	100.0	387
Springerville Station	2	Springerville, AZ	1990	Coal	390	TEP	100.0	390
San Juan Station	1	Farmington, NM	1976	Coal	340	PNM	50.0	170
San Juan Station	2	Farmington, NM	1973	Coal	340	PNM	50.0	170
Navajo Station	1	Page, AZ	1974	Coal	750	SRP	7.5	56
Navajo Station	2	Page, AZ	1975	Coal	750	SRP	7.5	56
Navajo Station	3	Page, AZ	1976	Coal	750	SRP	7.5	56
Four Corners Station	4	Farmington, NM	1969	Coal	784	APS	7.0	55
Four Corners Station	5	Farmington, NM	1970	Coal	784	APS	7.0	55
Luna Energy Facility	1	Deming, NM	2006	Gas	570	PNM	33.3	190
Sundt Station	1	Tucson, AZ	1958	Gas/Oil	81	TEP	100.0	81
Sundt Station	2	Tucson, AZ	1960	Gas/Oil	81	TEP	100.0	81
Sundt Station	3	Tucson, AZ	1962	Gas/Oil	104	TEP	100.0	104
Sundt Station <sup>(1)</sup>	4	Tucson, AZ	1967	Coal/Gas	156	TEP	100.0	156
DeMoss Petrie		Tucson, AZ	1972	Gas/Oil	122	TEP	100.0	122
North Loop		Tucson, AZ	2001	Gas	95	TEP	100.0	95
Springerville Solar Station		Springerville/Tucson, AZ	2002-2005	Solar	5	TEP	100.0	5
Total TEP Capacity <sup>(2)</sup>								<u>2,229</u>

<sup>(1)</sup> Leased assets, as of December 31, 2009.

<sup>(2)</sup> Excludes 781MW of additional resources, which consist of certain capacity purchases and interruptible retail load. At December 31, 2009, total owned capacity was 1,686 MW and leased capacity was 543 MW.

**Springerville Generating Station**

Springerville Unit 1 is leased by TEP. The Springerville Generating Station also includes the Springerville Coal Handling Facilities and the Springerville Common Facilities.

The terms of the Springerville Unit 1 Leases, which include a 50% interest in the Springerville Common Facilities, expire in 2015, but have optional fair market value renewal and purchase provisions. In 1985, TEP sold and leased back a 50% interest in the Springerville Common Facilities. The Springerville Common Facilities Leases, which expire in 2017 and 2021, have a fixed price purchase provision. The fixed prices to acquire the leased interests in the Springerville Common Facilities are \$38 million in 2017 and \$68 million in 2021. In 1984, TEP sold and leased back the Springerville Coal Handling Facilities. The terms of the Springerville Coal Handling Facilities Leases expire in 2015, but have a fixed price purchase provision of \$120 million.

Since entering into the Springerville leases, TEP has purchased a 14% equity ownership interest in the Springerville Unit 1 Leases and a 13% equity ownership interest in the Springerville Coal Handling Facilities Leases.

### **Sundt Generating Station**

The Sundt Generating Station and the internal combustion turbines located in Tucson are designated as “must-run generation” facilities. Must-run generation units are required to run in certain circumstances to maintain distribution system reliability and to meet local load requirements.

Sundt Unit 4 is leased by TEP and the term of the lease expires in 2011. In January 2010, TEP entered into an agreement to purchase 100% of the equity interest in Sundt Unit 4 from the equity owner for approximately \$52 million. The purchase price is subject to increase by 0.75% of the purchase price per month in the event that the purchase occurs after March 31, 2010. TEP expects the purchase to occur prior to March 31, 2010. Following the completion of the transaction, TEP expects to redeem the outstanding Sundt Unit 4 lease obligation of \$5 million, terminate the lease and cause the title of Sundt Unit 4 to be transferred to TEP.

See *Note 6 of Notes to Consolidated Financial Statements, Debt, Credit Facilities, and Capital Lease Obligations, and Item 7. — Management’s Discussion and Analysis of Financial Condition and Results of Operations, Tucson Electric Power Company, Liquidity and Capital Resources, Contractual Obligations*, for more information regarding the Springerville and Sundt leases.

### **Renewable Energy Resources**

#### Owned Resources

The Springerville Solar Generating Station includes 34,980 photovoltaic (PV) modules located near TEP’s coal-fired Springerville Generating Station in eastern Arizona. TEP began building the system in 2000 and continued to expand it for several years until its capacity reached 4.6 megawatts in 2004. A proposal to expand its capacity to 6.4 MW in 2010 is pending before the ACC.

TEP also has proposed a 1.6 MW PV installation in Tucson, Arizona. If approved by the ACC, the project is expected to be completed in the second half of 2010.

#### Purchased Power Agreements

In September 2009, TEP filed two 20 year purchased power agreements with the ACC in order to meet the requirements of the ACC’s Renewable Energy Standard and Tariff (REST). The first agreement would provide TEP with 25 MW of energy from a single axis tracking PV installation. The second agreement would provide TEP with 5 MW of energy from a parabolic trough concentrating solar facility. Each agreement contains an option that would allow TEP to purchase all or part of the project at a future period. TEP cannot predict when or if the ACC will approve the agreements. See *Renewable Energy Standard and Tariff*, below for more information.

### **Purchases and Interconnections**

TEP purchases power from other utilities and power marketers. TEP may enter into contracts: (a) to purchase energy under long-term contracts to serve retail load and long-term wholesale contracts, (b) to purchase capacity or energy during periods of planned outages or for peak summer load conditions, and (c) to purchase energy for resale to certain wholesale customers under load and resource management agreements.

TEP typically uses generation from its gas-fired units supplemented by purchased power to meet the summer peak demands of its retail customers. Some of these purchased power contracts are price indexed to natural gas prices. Due to its increasing seasonal gas and purchased power usage, TEP hedges a portion of its total natural gas exposure from plant fuel and gas-indexed purchased power with fixed price contracts for a maximum of three years. TEP also purchases energy in the daily and hourly markets to meet higher than anticipated demands, to cover unplanned generation outages, or when it is more economical than generating its own energy.

TEP is a member of various regional reserve sharing, reliability and power sharing organizations. These relationships allow TEP to call upon other utilities during emergencies, such as plant outages and system disturbances, and reduce the amount of reserves TEP is required to carry.

As a result of the Energy Policy Act of 2005, owners and operators of bulk power transmission systems, including TEP, are subject to mandatory reliability standards that are developed and enforced by the North American Electric Reliability Corporation (NERC) subject to the oversight of the Federal Energy Regulatory Commission (FERC). TEP is reviewing its operating policies and procedures to ensure continued compliance with these standards.

### Springerville Units 3 and 4

Springerville Units 3 and 4 are each 400 MW coal-fired generating facilities located at the same site as Springerville Units 1 and 2 that are operated, but not owned by TEP. Tri-State is leasing 100% of Unit 3 from a financial owner. Unit 4 began commercial operation in December 2009 and is owned by SRP. For operating Units 3 and 4, TEP receives rental payments and other fees, including the allocation of a portion of the fixed costs of the existing common facilities to Units 3 and 4. See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations. Tucson Electric Power Company, Factors Affecting Results of Operations, Springerville Units 3 and 4.*

### Peak Demand and Resources

<u>Peak Demand</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
			-MW-		
Retail Customers	2,354	2,376	2,386	2,365	2,225
Firm Sales to Other Utilities	385	394	369	331	342
Coincident Peak Demand (A)	2,739	2,770	2,755	2,696	2,567
Total Generating Resources	2,229	2,204	2,204	2,194	2,004
Other Resources <sup>(1)</sup>	781	966	785	719	788
Total TEP Resources (B)	3,010	3,170	2,989	2,913	2,792
Total Margin (B) — (A)	271	400	234	217	225
Reserve Margin (% of Coincident Peak Demand)	10%	14%	8%	8%	9%

<sup>(1)</sup> Other Resources include firm power purchases and interruptible retail and wholesale loads. Additional firm power purchases were made in 2009 to displace more expensive owned gas generation.

Peak demand occurs during the summer months due to the cooling requirements of TEP's retail customers. Retail peak demand varies from year-to-year due to weather, economic conditions and other factors. TEP's retail demand peaked in 2007 and subsequently declined in 2008 and 2009 due primarily to weak economic conditions.

The chart above shows the relationship over a five-year period between TEP's peak demand and its energy resources. TEP's total margin is the difference between total energy resources and coincident peak demand, and the reserve margin is the ratio of margin to coincident peak demand. TEP's reserve margin in 2009 was in compliance with reliability criteria set forth by the Western Electricity Coordinating Council, a regional council of NERC.

Forecasted retail peak demand for 2010 is approximately 2,284 MW, compared with actual peak demand of 2,354 MW in 2009. In 2009, cooling degree days were 13% above the ten year average. TEP's 2010 estimated retail peak demand is based on normal weather patterns and total retail kWh sales similar to 2009 levels. TEP believes it will have sufficient resources to meet expected demand in 2010 with its existing generation capacity and power purchase agreements.

### Future Generating Resources

TEP will continue to add peaking resources to serve the Tucson area as needed based upon our forecasts of retail and firm wholesale load, as well as statewide transmission infrastructure. TEP projects that additional import capacity and/or additional local generation resources of 75 to 150 MW may be required in 2015.

**FUEL SUPPLY****Fuel Summary**

Fuel cost and usage information is provided below:

	Average Cost per MMBtu Consumed			Percentage of Total Btu Consumed		
	2009	2008	2007	2009	2008	2007
Coal	\$ 2.11	\$ 2.08	\$ 1.81	90%	93%	92%
Gas	\$ 4.51	\$ 8.02	\$ 8.30	10%	7%	8%
All Fuels	\$ 2.34	\$ 2.52	\$ 2.30	100%	100%	100%

**Coal**

TEP's principal fuel for electric generation is low-sulfur, bituminous or sub-bituminous coal from mines in Arizona, New Mexico and Colorado. More than 90% of TEP's coal supply is purchased under long-term contracts, which results in more predictable prices. The average cost per ton of coal, including transportation, for 2009, 2008, and 2007 was \$39.81, \$39.67, and \$34.71, respectively .

Station	Coal Supplier	Contract Expiration	Average Sulfur Content	Coal Obtained From (A)
Springerville	Peabody Coalsales Company	2020	0.9%	Lee Ranch Coal Company
Four Corners	BHP Billiton	2016	0.8%	Navajo Indian Tribe
San Juan	San Juan Coal Company	2017	0.8%	Federal and State Agencies
Navajo	Peabody Coalsales Company	2011	0.4%	Navajo and Hopi Indian Tribes
Sundt	Rio Tinto Energy America / Chevron Mining Company	—	0.4%	Colowyo Mine / McKinley Mine

(A) Substantially all of the suppliers' mining leases extend at least as long as coal is being mined in economic quantities.

**TEP Operated Generating Facilities**

TEP is the operator, and the sole owner (or lessee), of the Springerville Units 1 and 2 and Sundt Unit 4 Generating Stations. The coal supplies for the Springerville Units 1 and 2 are transported approximately 200 miles by railroad from Northwestern New Mexico. TEP expects coal reserves to be sufficient to supply the estimated requirements for Springerville Units 1 and 2 for their presently estimated remaining lives.

The coal supplies for Sundt are transported approximately 1,300 miles by railroad from Colorado and approximately 500 miles from New Mexico. In the past, Sundt Unit 4 has been fueled by coal; however, the generating station can also be operated with natural gas or landfill gas. Both fuels are combined with methane, a renewable energy resource, piped from a nearby landfill. From January through October 2009, TEP used natural gas to fuel Sundt Unit 4. TEP hedged the price of natural gas such that it became more economic to use natural gas instead of coal to fuel the plant. TEP had agreements for the purchase and transportation of coal to Sundt through 2009 and has adequate coal inventory through 2010. TEP will continue to analyze natural gas prices to determine the fuel it will use to run Sundt Unit 4.

See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, UniSource Energy Consolidated, Contractual Obligations and Note 4 of Notes to Consolidated Financial Statements — Commitments and Contingencies, TEP Commitments, Firm Purchase and Transportation Commitments.*

### Generating Facilities Operated by Others

TEP also participates in jointly-owned generating facilities at Four Corners, Navajo and San Juan. Four Corners and San Juan, operated by PNM, are mine mouth generating stations located adjacent to the coal reserves. Navajo, operated by SRP, obtains its coal supply from a nearby coal mine and a dedicated rail delivery system. The coal supplies are under long-term contracts administered by the operating agents. TEP expects coal reserves available to these three jointly-owned generating facilities to be sufficient for the remaining presently estimated lives of the stations.

### **Natural Gas Supply**

TEP typically uses generation from its facilities fueled by natural gas and purchased power, in addition to energy from its coal-fired facilities, to meet the summer peak demands of its retail customers and local reliability needs. Some of these purchased power contracts are price indexed to natural gas prices. Short-term and spot power purchase prices are also closely correlated to natural gas prices. Due to its increasing seasonal gas and purchased power usage, TEP hedges a portion of its total natural gas exposure from plant fuel, gas-indexed purchased power and spot market purchases with fixed price contracts for a maximum of three years.

TEP purchases gas from Southwest Gas Corporation (SWG) under a retail tariff for North Loop, a 95 MW internal combustion turbine located in Tucson, Arizona, and receives distribution service under a transportation agreement for DeMoss Petrie, a 122 MW internal combustion turbine located in Tucson, Arizona. TEP completed a bypass of SWG and connected the Sundt plant directly to El Paso Natural Gas Company (ENPG) in the first quarter of 2008. TEP purchases capacity from EPNG for transportation from the San Juan and Permian Basins to its Sundt plant under a contract that expires in April 2013, with right-of-first refusal for continuation thereafter. TEP buys gas from third party suppliers for Sundt and DeMoss Petrie.

TEP purchases gas transportation for Luna from EPNG from the Permian Basin to the plant site under an agreement that expires in January 2012, with right-of-first refusal for continuation thereafter. TEP purchases gas for its share of Luna from various suppliers in the Permian Basin region.

### **WATER SUPPLY**

The Four Corners region of New Mexico, where the San Juan and Four Corners Generating Stations (San Juan and Four Corners) are located, experiences drought conditions periodically that could affect the water supply for these plants. The operating agents for San Juan and Four Corners have negotiated supplemental water contracts with BHP Billiton and the Jicarilla Apache Nation to assist the generating plants in meeting their water requirements in the event of a shortage.

Drought conditions within the Southwestern United States, combined with increased water usage in Arizona, Nevada and Southern California, have periodically caused water levels to recede at Lake Powell, which supplies operating water for the Navajo Generating Station (Navajo). TEP has a 7.5% ownership interest in Navajo Units 1, 2 and 3 (168 MW capacity). A project was completed in December 2009, which lowered the water intake structures to ensure adequate water supply at Navajo in the event drought conditions adversely affect the water level at Lake Powell.

### **TRANSMISSION ACCESS**

TEP has transmission access and power transaction arrangements with over 120 electric systems or suppliers. TEP is taking steps to increase the capacity and reliability of its transmission and distribution system. TEP also has various ongoing projects that are designed to increase access to the regional wholesale energy market and improve the reliability and efficiency of its existing transmission and distribution systems.

In 2008, TEP completed construction of a new 500 kV transmission line from the Palo Verde regional market hub to the Pinal West substation along with a new 345 kV TEP substation at Pinal West connecting to TEP's 345kV transmission line between Phoenix and Tucson. These projects provide TEP with additional access to energy resources.

TEP is participating in the continuation of the 500 kV transmission line from the Pinal West substation to the Pinal Central substation. TEP is also in the process of obtaining permits to construct a 40 mile 500-kV transmission line from the Pinal Central substation to the Tortolita substation northwest of Tucson to further enhance its ability to access the region's energy resources. TEP expects the transmission lines to be in-service in 2014. As a result of these high voltage transmission additions, TEP anticipates that its ability to import energy into its service territory should increase by at least 250 MW.

### **Tucson to Nogales Transmission Line**

TEP and UNS Electric are parties to a project development agreement initiated in 2000 for the joint construction of a 62-mile transmission line from Tucson to Nogales, Arizona. The project was initiated in response to an order by the ACC to improve reliability to UNS Electric's retail customers in Nogales, Arizona. Since receiving ACC approval of the location and construction of the proposed 345-kV transmission line along a specified route, TEP has been working to obtain all other required permits from state and federal agencies. The Department of Energy completed a Final Environmental Impact Statement (FEIS) for the project accepting any of the routes identified in the FEIS. The U.S. Forest Service, however, prefers a route that was not approved by the ACC.

Based on the alternative proposals and passage of time since the ACC approved the location of the line, in 2006 the Line Siting Committee of the ACC was directed to gather facts related to options for improving service reliability in Nogales, Arizona. TEP continues to evaluate alternatives for improving service reliability in Nogales, Arizona. In 2007 and 2008, TEP met with major property owners and impacted governmental agencies along the proposed transmission line routes to discuss alternatives. If all regulatory approvals are received and the project moves forward, the future costs to construct the transmission line from Tucson to Nogales, Arizona are expected to be approximately \$120 million. As of December 31, 2009, TEP had capitalized \$11 million related to the project, including \$2 million of land and land rights. If TEP does not receive the required approvals or abandons the project, TEP believes that 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, Arizona area.

TEP met with the Federal Electricity Commission of Mexico (CFE) and other transmission developers in 2009 to develop a schedule for performing transmission studies to interconnect the proposed Tucson to Nogales transmission line to a new CFE proposed 400-kV transmission line in Mexico. The studies are scheduled to be completed in 2010.

## **RATES AND REGULATION**

### **2008 TEP Rate Order**

On November 25, 2008, the ACC issued an order that resolved a rate case filed by TEP in July 2007. The ACC order included an average base retail rate increase of approximately 6% effective December 1, 2008 and a Purchased Power and Fuel Adjustment Clause (PPFAC) that began January 1, 2009. Prior to the 2008 TEP Rate Order, TEP's rates had remained unchanged since 2000.

The 2008 TEP Rate Order requires TEP to credit \$58 million of previously collected Fixed CTC true-up revenues to customers through the PPFAC. TEP expects the PPFAC charge to be zero until the Fixed CTC true-up revenues are fully credited over an estimated period of 36 to 48 months, which began on April 1, 2009.

For a more detailed description of the terms of the 2008 TEP Rate Order, see *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, Tucson Electric Power Company, Factors Affecting Results of Operations, 2008 TEP Rate Order*, below.

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

The ACC's REST requires TEP and other affected utilities to generate or purchase at least 15% of their total annual retail energy requirements from renewable energy technologies by 2025, with smaller amounts required in earlier years. The REST rules provide for recovery of above market costs a utility incurs in providing the renewable energy. TEP met the 2009 REST rules' target of generating or purchasing renewable energy for at least 2.0% of TEP's total retail energy requirements; TEP expects to meet the REST rules' 2010 target of 2.5%.

For more information see *Renewable Energy Resources*, above, and *Item 7. Management's Discussion and Analysis, Tucson Electric Power, Factors Affecting Results of Operations, Renewable Energy Standard and Tariff*.

### **Electric Energy Efficiency Standards**

In December 2009, the ACC established a process to adopt new Electric Energy Efficiency Standards (EE Standards) designed to require TEP, UNS Electric and other affected utilities to implement demand-side management (DSM) programs, to the extent that they are cost effective. If the ACC approves EE Standards, they must be certified by the Arizona Attorney General before taking effect. TEPs DSM programs and customer surcharge to recover the costs incurred to implement these proposed programs are subject to ACC approval. See *Item 7. – Management's Discussion and Analysis of Financial Condition and Results of Operations, TEP, Factors Affecting Results of Operations, Electric Energy Efficiency Standards*, for more information.

### **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 ESPs to compete in the retail market were invalidated by an Arizona Court of Appeals decision in 2005. In 2008, the ACC opened an administrative proceeding to address the Rules. Unless and until the ACC clarifies the competition rules and ESPs offer to provide energy in TEP's service area, it is not possible for TEP's retail customers to use alternative ESPs. We cannot predict what changes, if any, the ACC will make to the Rules. See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, Tucson Electric Power Company, Factors Affecting Results of Operations, Competition*, for more information.

### **Line Extension Policy**

In 2008, the ACC approved a policy requiring TEP to charge customers for the total cost of line extensions, eliminating TEP's prior practice of providing a portion of line extensions free of charge to its customers. The policy became effective June 1, 2009. Prior to this ruling by the ACC, a portion of the cost of line extensions was capitalized by TEP and eligible for inclusion in rate base.

## TEP'S UTILITY OPERATING STATISTICS

For Years Ended December 31,

	2009	2008	2007	2006	2005
Generation and Purchased Power — kWh (000)					
Remote Generation (Coal)	9,576,873	10,438,864	11,001,318	10,854,710	10,059,315
Local Tucson Generation (Oil, Gas & Coal)	711,420	1,039,362	1,088,778	966,476	1,165,001
Purchased Power	3,085,805	2,947,749	2,046,864	1,680,495	1,638,737
Total Generation and Purchased Power	13,374,098	14,425,975	14,136,960	13,501,681	12,863,053
Less Losses and Company Use	948,463	954,643	944,024	885,120	806,168
Total Energy Sold	12,425,635	13,471,332	13,192,936	12,616,561	12,056,885

## Sales — kWh (000)

Residential	3,905,696	3,852,707	4,004,797	3,778,269	3,633,226
Commercial	1,988,356	2,034,453	2,057,982	1,959,141	1,855,432
Industrial	2,160,946	2,263,706	2,341,025	2,278,244	2,302,327
Mining	1,064,830	1,095,962	983,173	924,898	842,881
Public Authorities	250,915	255,817	247,430	260,767	241,119
Total — Electric Retail Sales	9,370,743	9,502,645	9,634,407	9,201,419	8,874,985
Electric Wholesale Sales	3,054,892	3,968,688	3,558,529	3,415,142	3,181,900
Total Electric Sales	12,425,635	13,471,332	13,192,936	12,616,561	12,056,885

## Operating Revenues (000)

Residential	\$ 377,761	\$ 351,079	\$ 362,967	\$ 343,459	\$ 330,614
Commercial	219,694	211,639	213,364	203,284	192,966
Industrial	163,720	164,849	168,279	165,068	165,988
Mining	61,033	55,619	48,707	43,724	39,749
Public Authorities	19,865	19,146	18,332	18,935	17,559
REST and DSM	25,443	2,781	—	—	—
EFPS	—	415	4,822	2,684	2,624
Total — Electric Retail Sales	867,516	805,528	816,471	777,154	749,500
CTC To Be Refunded	—	(58,092)	—	—	—
Wholesale Revenue-Long Term	48,249	57,493	55,788	51,442	54,901
Wholesale Revenue-Short Term	83,456	185,189	125,369	112,309	117,557
California Power Exchange Provision for Wholesale Refunds	(4,172)	—	—	—	—
Transmission	18,974	17,173	14,842	13,391	7,250
Other Revenues	82,688	71,962	58,033	34,698	8,262
Total Operating Revenues	\$ 1,096,711	\$ 1,079,253	\$ 1,070,503	\$ 988,994	\$ 937,470

## Customers (End of Period)

Residential	365,157	363,861	361,945	357,646	350,628
Commercial	35,759	35,432	34,759	34,104	33,534
Industrial	629	633	641	664	673
Mining	2	2	2	2	2
Public Authorities	61	61	61	61	61
Total Retail Customers	401,608	399,989	397,408	392,477	384,898

## Average Retail Revenue per kWh Sold (cents)

Residential	9.7	9.1	9.1	9.1	9.1
Commercial	11.0	10.4	10.4	10.4	10.4
Industrial and Mining	7.0	6.6	6.6	6.6	6.5
Average Retail Revenue per kWh Sold	9.3	8.5	8.5	8.4	8.4

## Average Revenue per Residential Customer

\$ 1,034	\$ 965	\$ 1,003	\$ 971	\$ 954
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## Average kWh Sales per Residential

Customer

10,708

10,621

11,129

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10,681 10,484

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## ENVIRONMENTAL MATTERS

Air and water quality, resource extraction, waste disposal and land use are regulated by federal, state and local authorities. TEP believes that its facilities are in substantial compliance with existing regulations.

### Clean Air Act Requirements

TEP generating facilities are subject to EPA limits on the amount of sulfur dioxide (SO<sub>2</sub>), nitrogen oxide (NO<sub>x</sub>) and other emissions into the atmosphere. TEP capitalized \$24 million in 2009, \$73 million in 2008 and \$7 million in 2007 in construction costs to comply with environmental requirements, including TEP's share of new pollution control equipment installed at San Juan described below. TEP expects to capitalize environmental compliance costs of \$8 million in 2010 and \$5 million in 2011. In addition, TEP recorded operating expenses of \$13 million in 2009, \$14 million in 2008 and \$10 million in 2007 related to environmental compliance. TEP expects environmental expenses to be \$11 million in 2010. TEP may incur additional costs to comply with future changes in federal and state environmental laws, regulations and permit requirements at existing electric generating facilities. Compliance with these changes may reduce operating efficiency.

As a result of a 2005 settlement agreement between PNM, environmental activist groups, and the New Mexico Environment Department (PNM Consent Decree), the co-owners of San Juan installed new pollution control equipment at the generating station to reduce mercury, particulate matter, NO<sub>x</sub>, and SO<sub>2</sub> emissions. TEP owns 50% of San Juan Units 1 and 2. The PNM Consent Decree includes stipulated penalties for non-compliance with specified emissions limits at San Juan. In 2008 and 2007, TEP's share of stipulated penalties at San Juan was \$1 million and \$2 million, respectively. TEP's share of stipulated penalties at San Juan during 2009 was less than \$1 million. TEP cannot deduct these penalties for income tax purposes. With the installation of new pollution control equipment designed to remedy emission violations, we do not expect to incur similar penalties in the future.

In April 2009, APS received a request from the EPA under section 114 of the Clean Air Act seeking information about Four Corners. Four Corners, which is operated by APS, is comprised of five coal-fired generating units. TEP has a 7% ownership interest in two units, totaling 110 MW. APS has responded to the EPA's request. TEP cannot predict the timing or outcome of this matter.

In 1993, the EPA allocated TEP's generating units SO<sub>2</sub> Emission Allowances based on past operational history. Beginning in 2000, TEP's generating units were required to hold Emission Allowances equal to the level of emissions in the compliance year or pay penalties and offset excess emissions in future years. To date, TEP has held sufficient Emission Allowances to comply with the SO<sub>2</sub> regulations.

### Hazardous Air Pollutant Requirements

The Clean Air Act requires the EPA to develop an emission limit for hazardous air pollutants that represents the maximum achievable control technology. In October 2009, EPA entered into a consent order to develop a final rule by November 2011.

Depending on the stringency of the EPA rule, emission controls for mercury may be required at some or all coal fired units by 2014 or later. Whether controls are required at a particular unit, the level of control required, and the cost to achieve that level of control will not be known until the rule has been promulgated.

As stipulated in the PNM Consent Decree described above, the co-owners of San Juan installed new pollution control equipment at the generating station to reduce mercury emissions. The installation of mercury emissions controls for San Juan Units 1 and 2 were completed in 2009. These controls are expected to be adequate to achieve compliance with the federal standard.

Arizona adopted mercury emission rules in 2007 requiring a 90% reduction in emission from coal fired units. Due to potential inconsistency between the Arizona rule and the pending EPA rule, in January, 2009, TEP and ADEQ reached an agreement that (1) defers the 90% reduction requirement to 2016, (2) improves regulatory certainty regarding mercury compliance obligations under existing Arizona rules, and (3) achieves mercury reductions substantially similar to those that would be required by the existing Arizona rules. This agreement relates to the Springerville and Sundt generating stations.

In order to comply with the Arizona rule, TEP expects mercury emission control equipment may be required at Springerville by 2016. The associated capital cost for this equipment is estimated to be \$6 million at Springerville Units 1 and 2. If the emission control equipment is installed, TEP expects the annual operating expenses to be approximately \$3 million, once all installations are completed.



## Climate Change

In 2007, the Supreme Court ruled in *Commonwealth of Massachusetts, et al v. EPA*, that carbon dioxide (CO<sub>2</sub>) and other greenhouse gases (GHG) are air pollutants under the Clean Air Act. In December 2009, EPA issued a final Endangerment Finding, stating that greenhouse gases endanger public health and welfare. This finding allows EPA to promulgate regulations limiting emissions of greenhouse gases. EPA is in the process of developing regulation limiting greenhouse gases, which once finalized, may impact future generation or modifications of existing plants.

Several pieces of legislation have been introduced at the federal level. In June 2009, the House of Representatives passed the American Clean Energy and Security legislation which included a cap and trade program for GHG. The Senate is considering similar cap and trade legislation with the September 2009 introduction of the Clean Energy Jobs and American Power bill. While debate continues at the national level over the direction of domestic climate policy, several states have developed state-specific policies or regional initiatives to reduce greenhouse gas 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) that directed their respective states to develop a regional target for reducing greenhouse gases. The states in the Western Climate Initiative announced a target of reducing greenhouse gas 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 greenhouse gas emissions, with an implementation date set for 2012. In February 2010, the Governor of Arizona issued an executive order which, among other things, stated that Arizona will not implement the GHG cap-and-trade proposal advanced by the Western Climate Initiative. The executive order expires December 31, 2012.

Based on the competing proposals to regulate greenhouse gas 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

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 operators of the San Juan, Four Corners, and Navajo generating stations submitted BART analyses in 2007 and early 2008. PNM, operator of San Juan, believes the controls being installed at San Juan as a result of the PNM Consent Decree constitute BART and did not recommend installation of any additional pollution control equipment. APS and SRP, the operators of the Four Corners and Navajo generating stations, respectively recommended installing certain additional pollution control equipment in their respective BART analyses. TEP's share of the cost for the APS recommended pollution control upgrades at Four Corners is estimated to be \$6 million. SRP has initiated the pollution control upgrades at Navajo on a voluntary basis. TEP's \$3 million share of these costs is included in the cost estimates section on Clean Air Act Requirements above.

In August 2009, EPA issued an Advanced Notice of Proposed Rulemaking requesting comment on the cost effectiveness and expected visibility improvements of different levels of air pollution controls at Four Corners and Navajo including Selective Catalytic Reduction (SCR). If SCR is determined by the EPA to be BART, the capital cost impact to TEP is estimated to be \$42 million for Four Corners, and \$50 million for Navajo. The exact level and cost of pollution control required will not be known until final determinations are made by the regulatory agencies. Under the current proposal, controls would need to be in place no earlier than five years following the final determination.

The Four Corners and Navajo Plant participants' obligations to comply 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 these plants or the ability of individual participants to meet their obligations and continue their participation in these plants.

## **Coal Combustion Byproducts**

The EPA is expected to issue proposed regulations governing the handling and disposal of coal combustion byproducts (CCBs), such as fly ash. The EPA is evaluating options that include regulation of CCBs under solid waste standards, hazardous waste standards, or a combination of both. A proposed rule is expected during the first quarter of 2010. The financial impact to TEP, if any, cannot be determined at this time.

## **Ozone National Ambient Air Quality Standard**

In January 2010, EPA issued a proposed rule to reduce the National Ambient Air Quality Standard for Ozone. Based on the proposed standard, certain counties in which TEP conducts operations could be in violation of the standard. The financial impact to TEP, if any, cannot be determined at this time.

## **UNS GAS**

### **SERVICE TERRITORY AND CUSTOMERS**

UNS Gas is a gas distribution company serving approximately 146,000 retail customers in Mohave, Yavapai, Coconino, and Navajo counties in Northern Arizona, as well as Santa Cruz County in Southeast Arizona. These counties comprise approximately 50% of the territory in the state of Arizona, with a population of approximately 700,000. From 2003 to 2007, customer growth in UNS Gas' service territory averaged 3% per year, compared with zero growth in 2008 and less than 1% growth in 2009 in the number of retail customers. As a result of weak economic conditions and mild weather, the average energy use by retail customers during 2008 and 2009 was below the average levels experienced by UNS Gas in prior periods.

UNS Gas' customer base is primarily residential. Revenues derived from residential customers were approximately 61% of total revenues in 2009, while sales to other retail customer classes accounted for approximately 28% of total revenues. Approximately 11% of total revenues in 2009 were derived from gas transportation services and a Negotiated Sales Program (NSP). UNS Gas supplies natural gas transportation service to the 600 MW Griffith Power Plant located near Kingman, Arizona, under a 20-year contract which expires in 2021. UNS Gas also supplies natural gas to some of its large transportation customers through an NSP approved by the ACC. One half of the margin earned on these NSP sales is retained by UNS Gas, while the other half benefits retail customers through a credit to the purchased gas adjustor (PGA) mechanism which reduces the gas commodity price.

In 2008, UNS Gas and UNS Electric entered into a 20-year gas transportation agreement and a 20-year natural gas sales agreement, whereby UNS Gas will purchase natural gas for UNS Electric and transport it to BMGS.

### **GAS SUPPLY AND TRANSMISSION**

UNS Gas directly manages its gas supply and transportation contracts. The market price for gas varies based upon the period during which the commodity is purchased. UNS Gas hedges its gas supply prices by entering into fixed price forward contracts and financial swaps at various times during the year to provide more stable prices to its customers. These purchases and hedges are made up to three years in advance with the goal of hedging at least 45% of the expected monthly gas consumption with fixed prices prior to entering into the month.

UNS Gas buys most of the gas it distributes from the San Juan Basin in the Four Corners region. The gas is delivered on the El Paso Natural Gas Company (EPNG) and Transwestern Pipeline Company (Transwestern) interstate pipeline systems under firm transportation agreements with combined capacity sufficient to meet UNS Gas' customers' demands.

With EPNG, the average daily capacity right of UNS Gas is approximately 655,000 therms per day, with an average of 1,095,000 therms per day in the winter season (November through March) to serve its Northern and Southern Arizona service territories. UNS Gas has capacity rights of 250,000 therms per day on the San Juan Lateral and Mainline of the Transwestern pipeline. The Transwestern pipeline principally delivers gas to the portion of UNS Gas' distribution system serving customers in Flagstaff and Kingman, Arizona, and also delivers gas to UNS Gas' facilities serving the Griffith Power Plant in Mohave County.

UNS Gas signed a separate transportation agreement with Transwestern for transportation capacity rights on the Phoenix Lateral Extension Line. The 15-year agreement began in March 2009, when construction of that pipeline was completed. UNS Gas' average daily capacity right will be 126,100 therms per day, with an average of 221,900 therms per day in the winter season (November through March).

See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, UNS Gas, Liquidity and Capital Resources, Contractual Obligations, UNS Gas Supply Contracts*, for more information.

## RATES AND REGULATION

The ACC regulates UNS Gas with respect to retail gas rates, the issuance of securities, and transactions with affiliated parties. UNS Gas' retail gas rates include a monthly customer charge, a base rate charge for delivery services and the cost of gas (expressed in cents per therm), and a PGA.

### Purchased Gas Adjustor

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. See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, UNS Gas, Factors Affecting Results of Operations, Rates and Regulation, Energy Cost Adjustment Mechanism*, for more information.

### 2008 General Rate Case

In November 2008, UNS Gas filed a general rate case with the ACC on a cost of service basis. Below is a table that summarizes UNS Gas' request:

Test year — 12 months ended June 30, 2008	Requested by UNS Gas
Original cost rate base	\$182 million
Revenue deficiency	\$9.5 million
Total rate increase (over test year revenues)	6%
Cost of long-term debt	6.5%
Cost of equity	11.0%
Actual capital structure	50% equity / 50% debt
Weighted average cost of capital	8.75%
Rate of return on fair value rate base	6.80%

On June 8, 2009, the ACC staff and other intervenors filed testimony in this proceeding. The ACC staff recommended a rate increase of \$3.4 million based on an original cost rate base of \$178 million and a 10% ROE. Hearings before an administrative law judge concluded in August 2009. UNS Gas expects the ACC to issue a final order in the first half of 2010. UNS Gas cannot predict the outcome of this general rate case proceeding. See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, UNS Gas, Rates, 2008 General Rate Case Filing*, for more information.

## ENVIRONMENTAL MATTERS

UNS Gas is subject to environmental regulation of air and water quality, resource extraction, waste disposal and land use by federal, state and local authorities. UNS Gas believes that its facilities are in substantial compliance with all existing regulations. See *Item 1 — Business, TEP, Environmental Matters*, for more information.

## UNS ELECTRIC

### SERVICE TERRITORY AND CUSTOMERS

UNS Electric is an electric transmission and distribution company serving approximately 90,000 retail customers in Mohave and Santa Cruz counties. These counties have a combined population of approximately 240,000. As a result of weak economic conditions, retail customer growth and average energy use by retail customers is below the average levels experienced by UNS Electric in prior periods. From 2003 to 2007, customer growth in UNS Electric's service territory averaged 3% per year, compared with no change in the average number of retail customers during 2008 and less than 1% growth 2009. UNS Electric's customer base is primarily residential, with some small commercial and both light and heavy industrial customers. Peak demand for 2009 was 559 MW.



## POWER SUPPLY AND TRANSMISSION

### Power Supply

In 2008, UNS Electric and UED entered into a Power Purchase and Sales Agreement (PPA) under which UED sells all the output of the 90 MW gas-fired Black Mountain Generating Station (BMGS) to UNS Electric over a five-year term. The PPA is a tolling arrangement in which UNS Electric operates BMGS and assumes all risk of operation and maintenance costs, including fuel. Under the terms of the PPA, UNS Electric pays UED a capacity charge. The costs associated with the PPA are recoverable through UNS Electric's PPFAC.

UNS Gas and UED have a 20-year gas transportation agreement and a 20-year natural gas sales agreement, whereby UNS Gas will purchase and transport natural gas for UED to BMGS.

UNS Electric owns and operates the Valencia Power Plant (Valencia), located in Nogales, Arizona. Valencia consists of four gas and diesel-fueled combustion turbine units and provides approximately 68 MW of peaking resources. The facility is directly interconnected with the distribution system serving the city of Nogales and the surrounding areas.

In addition to the PPA with UED and the output from Valencia, UNS Electric relies on a portfolio of long, intermediate and short-term purchases to meet customer load requirements.

See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, UNS Electric, Liquidity and Capital Resources, Contractual Obligations and Other Non-Reportable Business Segments, UED*, below for more information.

### Transmission

UNS Electric imports the power it purchases from UED into its Mohave County and Santa Cruz County service territories over Western Area Power Administration's (WAPA) transmission lines. UNS Electric has a network transmission service agreement for its primary transmission capacity with WAPA for the Parker-Davis system that expires in May 2017. UNS Electric also has a long-term electric point to point transmission capacity agreement with WAPA for the Southwest Intertie system that expires in 2011.

UNS Electric currently plans to upgrade its existing 115 kV transmission line to 138 kV by the end of 2012 to improve the reliability of service in Santa Cruz County. This upgrade is included in UNS Electric's current capital expenditures forecast. See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, UNS Electric, Liquidity and Capital Resources* for more information.

## RATES AND REGULATION

UNS Electric is regulated by the ACC with respect to retail electric rates, quality of service, the issuance of securities, and transactions with affiliated parties, and by the FERC with respect to wholesale power contracts and interstate transmission service. In 2007, UNS Electric was granted a FERC tariff to sell power at market based rates. UNS Electric's retail electric rates include a PPFAC, which allows for UNS Electric to recover the actual costs of its fuel and power purchases.

**2009 General Rate Case Filing**

In April 2009, UNS Electric filed a rate case application with the ACC, which is summarized below.

Test year — December 31, 2008

Original cost rate base	\$176 million
Revenue deficiency	\$13.5 million
Total rate increase (over test year revenues)	7.4%
Cost of debt	7.05%
Cost of equity	11.40%
Actual capital structure	46% equity / 54% debt
Weighted average cost of capital	9.04%
Fair Value Rate Base	\$265 million
Rate of Return on Fair Value Rate Base	6.88%

The filing also included a proposal to acquire, and put into its rate base, BMGS, the gas-fired facility in UNS Electric's service territory that is owned by UED. The proposed acquisition and inclusion of BMGS in rate base would not impact the amount of the total rate increase requested by UNS Electric.

On November 6, 2009, the ACC staff and other intervenors filed testimony in this proceeding. The ACC staff recommended a rate increase of \$7.5 million based on an original cost rate base of \$168 million and a 10% return on equity. A hearing before an ACC administrative law judge concluded in February 2010. See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, UNS Electric, Factors Affecting Results of Operations, Rates*, for more information.

**Electric Energy Efficiency Standards**

In December 2009, the ACC established a process to adopt new Electric Energy Efficiency Standards (EE Standards) designed to require TEP, UNS Electric and other affected utilities to implement demand-side management (DSM) programs, to the extent that they are cost effective. If the ACC approves EE Standards, they must be certified by the Arizona Attorney General before taking affect. TEP's DSM programs and customer surcharge to recover the costs incurred to implement these proposed programs are subject to ACC approval.

See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, UNS Electric, Factors Affecting Results of Operations, Electric Energy Efficiency Standards*, for more information.

**Line Extension Policy**

As part of the May 2008 ACC order, UNS Electric is required to charge customers for the total cost of line extensions beginning in March 2010. Prior to this ruling by the ACC, a portion of the cost of line extensions was capitalized by UNS Electric and eligible for inclusion in rate base.

**ENVIRONMENTAL MATTERS**

UNS Electric is subject to environmental regulation of air and water quality, resource extraction, waste disposal and land use by federal, state and local authorities. UNS Electric believes that its facilities are in substantial compliance with all existing regulations and will be in compliance with expected environmental regulations. See *Item. 1 — Business, TEP, Environmental Matters*, for more information.

**Renewable Energy Standard and Tariff**

The REST rules require UNS Electric to generate or purchase at least 15% of its total annual retail energy requirements from renewable energy technologies by 2025, with smaller amounts required in earlier years. UNS Electric began implementing its ACC approved REST plan on June 1, 2008. UNS Electric met the REST rules' 2009 target of generating or purchasing renewable energy for at least 2% of UNS Electric's total retail energy requirements; UNS Electric expects to meet the 2010 requirement of 2.5%. See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, UNS Electric, Factors Affecting Results of Operations, Renewable Energy Standard and Tariff*, for more information.

## Renewable Energy Resources

In February 2010, UNS Electric requested the ACC approve a power purchase agreement that would provide UNS Electric with 11 MW of energy from wind turbine installation near Kingman, Arizona over a 20 year period. The above market cost of power under the agreement would be funded through UNS Electric's REST surcharge. UNS Electric cannot predict when or if the ACC will approve the agreement. See *Renewable Energy Standard and Tariff*, above for more information.

## OTHER

### UED

UED completed construction of the 90 MW BMGS in May 2008. See *UNS Electric, Power Supply and Transmission*, above for more information regarding BMGS.

## Millennium Investments

Through affiliates, Millennium holds investments in unregulated energy and emerging technology companies. At December 31, 2009, Millennium had an investment balance of \$10 million, a \$7 million cash balance and a \$15 million note, which in total represented less than 1% of UniSource Energy's total consolidated assets. UniSource Energy has ceased making loans or equity contributions to Millennium and has less than \$1 million of remaining funding commitments. See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, Other Non-Reportable Business Segments, Millennium Investments*, for more information.

### Sabinas

In June 2009, Millennium finalized a sale of its 50% interest in Sabinas. Millennium received an upfront \$5 million cash payment in January 2009. Other key terms of the transaction included a three year, 6% interest-bearing, collateralized \$15 million note. In June 2009, Millennium recorded a \$6 million pre-tax gain on the sale.

## **EMPLOYEES (As of December 31, 2009)**

TEP had 1,358 employees, of which approximately 54% are represented by the International Brotherhood of Electrical Workers (IBEW) Local No. 1116. A collective bargaining agreement between the IBEW and TEP expires in January 2013.

UNS Gas had 197 employees, of which 117 employees were represented by IBEW Local No. 1116 and 6 employees were represented by IBEW Local No. 387. The agreements with the IBEW Local No. 1116 and No. 387 expire in June 2012 and February 2011, respectively.

UNS Electric had 167 employees, of which 29 employees were represented by the IBEW Local No. 387 and 107 employees were represented by the IBEW Local No. 769. The existing agreement with the IBEW Local No. 387 and No. 769 expire in February 2011 and August 2010, respectively.

Southwest Energy Solutions, a wholly-owned subsidiary of Millennium, had 254 employees, of which approximately 95% are represented by unions. Of the employees represented by unions, 226 are represented by IBEW Local No. 1116 and 15 by IBEW Local No. 570; these agreements expire on February 2, 2012, and May 31, 2012, respectively.

**EXECUTIVE OFFICERS OF THE REGISTRANTS****Executive Officers — UniSource Energy**

Executive Officers of UniSource Energy, who are elected annually by UniSource Energy's Board of Directors, are as follows:

<b>Name</b>	<b>Age</b>	<b>Position(s) Held</b>	<b>Executive Officer Since</b>
Paul J. Bonavia	58	Chairman, President and Chief Executive Officer	2009
Michael J. DeConcini	45	Senior Vice President and Chief Operating Officer, Transmission and Distribution	1999
Raymond S. Heyman	54	Senior Vice President and General Counsel	2005
Kevin P. Larson	53	Senior Vice President, Chief Financial Officer and Treasurer	2000
Philip Dion III	41	Vice President, Legal and Environmental Services	2008
Kentton C. Grant	51	Vice President, Finance and Rates	2007
Arie Hoekstra	62	Vice President, Generation	2007
David G. Hutchens	43	Vice President, Energy Efficiency and Resource Planning	2007
Karen G. Kissinger	55	Vice President, Controller and Chief Compliance Officer	1998
Steven W. Lynn	63	Vice President, Communications and Government Relations	2003
Thomas A. McKenna	61	Vice President, Engineering	2007
Catherine E. Ries	50	Vice President, Human Resources	2007
Herlinda H. Kennedy	48	Corporate Secretary	2006

***Paul J. Bonavia***

Mr. Bonavia became Chairman, President and Chief Executive Officer of UniSource Energy and TEP in January 2009. Prior to joining UniSource Energy and TEP, Mr. Bonavia served as President of the Utilities Group of Xcel Energy. Mr. Bonavia previously served as President of Xcel Energy's Commercial Enterprises business unit and President of the company's Energy Markets unit.

***Michael J. DeConcini***

Mr. DeConcini joined TEP in 1988 and was elected Senior Vice President and Chief Operating Officer of the Energy Resources business unit of TEP, effective January 1, 2003. In August 2006, he was named Senior Vice President and Chief Operating Officer, Transmission and Distribution. In May 2009, he was named Senior Vice President and Chief Operating Officer.

***Raymond S. Heyman***

Mr. Heyman was elected to the position of Senior Vice President and General Counsel of TEP and UniSource Energy in September 2005. Prior to joining UniSource Energy and TEP, Mr. Heyman was a member of the Phoenix, Arizona law firm Roshka, Heyman & DeWulf, PLC.

***Kevin P. Larson***

Mr. Larson joined TEP in 1985 and thereafter held various positions in its finance department and at TEP's investment subsidiaries. He was elected Treasurer of TEP in August 1994 and Vice President in March 1997. In October 2000, he was elected Vice President and Chief Financial Officer of both UniSource Energy and TEP and serves as Treasurer of both organizations. He was named Senior Vice President in September 2005.

***Philip Dion III***

Mr. Dion was named Vice President of Legal and Environmental Services at UniSource Energy and TEP in February 2008. Prior to joining TEP, Mr. Dion was chief of staff and chief legal advisor to Commissioner Marc Spitzer of the Federal Energy Regulatory Commission. Mr. Dion previously worked in various roles at the ACC, including as an administrative law judge and as an advisor to Mr. Spitzer, prior to his appointment to FERC.

***Kentton C. Grant***

Mr. Grant joined TEP in 1995. In January 2007, Mr. Grant was elected Vice President of Finance and Rates at UniSource Energy and TEP.



<b>Arie Hoekstra</b>	Mr. Hoekstra joined TEP in 1979. In January 2007, Mr. Hoekstra was elected Vice President of Generation at UniSource Energy and TEP.
<b>David G. Hutchens</b>	Mr. Hutchens joined TEP in 1995. In May 2009, Mr. Hutchens was named Vice President of Energy Efficiency and Resource Planning. In January 2007, Mr. Hutchens was elected Vice President of Wholesale Marketing at UniSource Energy and TEP, and Vice President of UNS Gas.
<b>Karen G. Kissinger</b>	Ms. Kissinger joined TEP as Vice President and Controller in January 1991. She was named Vice President, Controller and Principal Accounting Officer of UniSource Energy in January 1998. She has served as Chief Compliance Officer of UniSource Energy and TEP since 2003.
<b>Steven W. Lynn</b>	Mr. Lynn joined TEP in 2000. In January 2003, he was elected Vice President of Communications and Government Relations at UniSource Energy and TEP.
<b>Thomas A. McKenna</b>	Mr. McKenna joined Nations Energy Corporation (a wholly-owned subsidiary of Millennium) in 1998. In May 2009, Mr. McKenna was named Vice President of UNS Gas. This is in addition to his position as Vice President of Engineering at UniSource Energy and TEP, and Vice President of UNS Electric, to which he was elected in January 2007.
<b>Catherine E. Ries</b>	Ms. Ries joined UniSource Energy and TEP in June 2007 as Vice President of Human Resources. Prior to joining UniSource Energy and TEP, Ms. Ries worked for Clopay Building Products, a division of Griffon Corporation, from 2000 to 2007 and held the position of Vice President of Human Resources prior to joining UniSource Energy and TEP.
<b>Herlinda H. Kennedy</b>	Ms. Kennedy joined TEP in 1980. Ms. Kennedy was named assistant Corporate Secretary of TEP and UniSource Energy in 1999 and was elected Corporate Secretary of UniSource Energy and TEP in September 2006.

#### **Executive Officers — TEP**

The executive officers of TEP are the same as UniSource Energy. See *Executive Officers — UniSource Energy*, above, for a listing and description of TEP's executive officers.

#### **SEC REPORTS AVAILABLE ON UNISOURCE ENERGY'S WEBSITE**

UniSource Energy and TEP make available their annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after they electronically file them with, or furnish them to, the Securities and Exchange Commission (SEC). These reports are available free of charge through UniSource Energy's website address: <http://www.uns.com>. A link from UniSource Energy's website to these SEC reports is accessible as follows: At the UniSource Energy main page, select Investors from the menu shown at the top of the page; next select SEC filings from the menu shown on the Investor Relations page. UniSource Energy's code of ethics, and any amendments made to the code of ethics, is also available on UniSource Energy's website.

Information contained at UniSource Energy's website is not part of any report filed with the SEC by UniSource Energy or TEP.

#### **ITEM 1A. — RISK FACTORS**

The business and financial results of UniSource Energy and TEP are subject to a number of risks and uncertainties, including those set forth below and in other documents we file with the SEC. These risks and uncertainties fall primarily into five major categories: revenues, regulatory, financial, environmental and operational.

#### **REVENUES**

**National and local economic conditions can have a significant impact on the results of operations, net income and cash flows at TEP, UNS Gas and UNS Electric.**

Economic conditions have contributed significantly to a reduction in TEP's retail customer growth and lower energy usage by the company's residential, commercial and industrial customers. From 2003 to 2007, customer growth in

TEP's service territory averaged approximately 2% per year. In 2008 and 2009, as economic conditions worsened, TEP's average retail customer base grew by less than 1%. In 2009, total retail kWh sales were 1.4% below 2008 levels. TEP estimates that a 1% decrease in annual retail sales could reduce pre-tax net income and pre-tax cash flows by approximately \$6 million.

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Similar impacts were felt at UNS Gas and UNS Electric. The retail customer bases at both companies did not grow during 2008 or 2009 compared with average annual growth rates of 3 to 4% from 2003 to 2007. We estimate that a 1% decrease in annual retail sales at UNS Gas and UNS Electric could reduce pre-tax net income and pre-tax cash flows by less than \$1 million.

**TEP's base rates are frozen through December 31, 2012, which could limit our ability to cope with the impact of risks and uncertainties and negatively affect TEP's results of operations, net income and cash flows.**

Under the terms of the 2008 TEP rate order, TEP is prohibited from submitting a base rate application before June 30, 2012 and new rates cannot go into effect prior to December 31, 2012. If the cost of serving TEP's customers rises more quickly than the revenues collected from customers, TEP's results of operations, net income and cash flows could be negatively impacted.

**New technological developments and increasing use of more energy efficient products may have a significant impact on retail sales, which could negatively impact UniSource Energy's results of operations, net income and cash flows.**

Heightened awareness of energy costs and general public support for energy efficiency has increased demand for products intended to reduce consumers' use of electricity. TEP and UNS Electric also are promoting Demand Side Management programs designed to help customers reduce their energy use, and these efforts may increase significantly under new energy efficiency rules given preliminary approval in 2009 by the ACC. Unless the ACC makes specific provision for the recovery of usage-based revenues lost to these energy efficiency programs, the reduced retail sales that would result from the success of these efforts would negatively impact the results of operations, net income and cash flows of TEP and UNS Electric.

**The revenues, results of operations and cash flows of TEP, UNS Gas and UNS Electric are seasonal, and are subject to weather conditions and customer usage patterns, beyond the companies' control.**

TEP typically earns the majority of its operating revenue and net income in the third quarter because retail customers increase their air conditioning usage during Tucson's hot summer weather. Conversely, TEP's first quarter net income is typically limited by relatively mild winter weather in its retail service territory. UNS Electric's earnings follow a similar pattern, while UNS Gas' sales peak in the winter during home heating season. Cool summers or warm winters may affect customer usage at all three companies, adversely affecting operating revenues, cash flows and net income by reducing sales.

## **REGULATORY**

**TEP, UNS Gas and UNS Electric are subject to regulation by the ACC, which sets the companies' retail rates and oversees many aspects of their business in ways that could negatively affect the companies' results of operations, net income and cash flows.**

The ACC is a constitutionally created body composed of five elected commissioners. Commissioners are elected state-wide for staggered four-year terms and are limited to serving a total of two terms. As a result, the composition of the commission, and therefore its policies, are subject to change every two years.

The ACC is charged with setting retail electric and gas rates that provide utility companies with an opportunity to recover their costs of service and earn a reasonable rate of return. The decisions these elected officials make on such matters impact the net income and cash flows of TEP, UNS Gas and UNS Electric.

**Changes in federal energy regulation may negatively affect TEP, UNS Gas and UNS Electric's results of operations, net income and cash flows.**

TEP, UNS Gas and UNS Electric are subject to comprehensive and changing governmental regulation at the federal level that continues to change the structure of the electric and gas utility industries and the ways in which these industries are regulated. UniSource Energy's electric utility subsidiaries are subject to regulation by the FERC. The FERC has jurisdiction over rates for electric transmission in interstate commerce and rates for wholesale sales of electric power, including terms and prices of transmission services and sales of electricity at wholesale prices.

**FINANCIAL**

**Financial market disruptions and volatility may increase our financing costs, limit our access to the credit markets and increase our pension funding obligations, which may adversely affect our liquidity and our ability to carry out our financial strategy.**

We rely on access to the bank markets and capital markets as a significant source of liquidity and for capital requirements not satisfied by the cash flow from our operations. Market disruptions such as those recently experienced in the United States and abroad may increase our cost of borrowing or adversely affect our ability to access sources of liquidity needed to finance our operations and satisfy our obligations as they become due. These disruptions may include turmoil in the financial services industry, including substantial uncertainty surrounding particular lending institutions and counterparties we do business with, unprecedented volatility in the markets where our outstanding securities trade, and general economic downturns in our utility service territories. If we are unable to access credit at competitive rates, or if our borrowing costs dramatically increase, our ability to finance our operations, meet our short-term obligations and execute our financial strategy could be adversely affected.

Changing market conditions could negatively affect the market value of assets held in our pension and other postretirement pension plans and may increase the amount and accelerate the timing of required future funding contributions.

**Financial market disruptions and volatility may increase our financing costs and adversely affect our ability to refinance debt obligations and credit agreements totaling \$671 million that expire or come due in 2011 at UniSource Energy, TEP, UNS Gas and UNS Electric.**

UniSource Energy, TEP, UNS Gas and UNS Electric are each party to a revolving credit agreement with a group of lenders. We rely on these agreements for working capital requirements not provided by cash flow from our operations. We cannot be assured that there will be sufficient lender interest and capacity to refinance these facilities prior to their expiration dates. The following credit agreements and debt obligations mature in August 2011:

Description	Amount
UniSource Energy Credit Agreement	\$70 million revolving credit facility
TEP Credit Agreement	\$491 million, consisting of a \$341 million letter of credit facility and a \$150 million revolving credit facility
UNS Gas/UNS Electric Revolver	\$60 million revolving credit facility
UNS Gas Senior Unsecured Notes	\$50 million

UniSource Energy, TEP, UNS Gas and UNS Electric could have difficulty obtaining funding under their respective revolving credit facilities when required if lenders in the bank group file for bankruptcy or refuse to fund when requested. If sufficient liquidity is not available to meet short-term working capital needs, if we are unable pay off or refinance our debt obligations or if borrowing costs dramatically increase, UniSource Energy, TEP, UNS Gas and UNS Electric's results of operations, net income and cash flows could be negatively impacted.

**Regulatory rules and other restrictions limit the ability of TEP, UNS Gas and UNS Electric to make distributions to UniSource Energy.**

As a holding company, UniSource Energy is dependent on the earnings and distributions of funds from its subsidiaries to service its debt and pay dividends to shareholders.

Restrictions include:

- TEP, UNS Gas and UNS Electric are restricted from lending or transferring funds or issuing securities without ACC approval;
- The Federal Power Act restricts electric utilities' ability to pay dividends out of funds that are properly included in their capital account. TEP has an accumulated deficit rather than positive retained earnings. 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. However, the FERC could attempt to stop TEP from paying further dividends or could seek to impose additional restrictions on the payment of dividends; and
- TEP, UNS Gas and UNS Electric must be in compliance with their respective debt agreements to make dividend payments to UniSource Energy.

**Economic conditions could adversely impact our ability to comply with financial covenants in the UniSource Energy and TEP Credit Agreements.**

The UniSource Energy and TEP credit and reimbursement agreements include a minimum cash flow to interest coverage ratio and a maximum leverage ratio. The leverage ratios are calculated as the ratio of total indebtedness to earnings before interest, taxes, depreciation and amortization. The ability to comply with these covenants could be adversely impacted by lower customer growth rates or sales during an economic downturn. In the event that we seek to renegotiate these provisions to provide additional flexibility, we may need to pay fees or increased interest rates on borrowings as a condition to any amendments or waivers.

**UniSource Energy's net income and cash flows can be adversely affected by rising interest rates.**

As of February 23, 2010, TEP had \$329 million of tax-exempt variable rate debt obligations. The interest rates on these debt obligations are set weekly with a maximum interest rate of 20%. The average weekly interest rate ranged from 0.25% to 0.79% in 2009. A 1% increase in the average interest rates on this debt, over a twelve month period, would result in an increase in interest expense by approximately \$3 million.

UniSource Energy, TEP, UNS Gas and UNS Electric also are subject to risk resulting from changes in the interest rate on their borrowings under revolving credit facilities. Revolving credit borrowings may be made on a spread over LIBOR or an Alternate Base Rate. Each of these agreements is a committed facility and expires in August 2011.

If capital market conditions result in rising interest rates, the resulting increase in the cost of variable rate borrowings would negatively impact UniSource Energy, TEP, UNS Gas and UNS Electric results of operations, net income and cash flows.

**TEP, UNS Gas and UNS Electric may be required to post margin under their power and fuel supply agreements which could negatively impact their liquidity.**

TEP, UNS Gas and UNS Electric secure power and fuel supply resources to serve their respective retail customers. The agreements under which TEP, UNS Gas and UNS Electric contract for such resources include requirements to post credit enhancement in the form of cash or letters of credit under certain circumstances, including changes in market prices which affect contract values, or a change in creditworthiness of the respective companies.

In order to post such credit enhancement, TEP, UNS Gas and UNS Electric would have to use available cash, draw under their revolving credit agreements, or issue letters of credit under their revolving credit agreements.

The maximum amount TEP may use under its revolving credit facility is \$150 million. As of February 23, 2010, TEP had \$99 million available to borrow under its revolving credit facility. The maximum amount UNS Gas or UNS Electric may use under their revolving credit facility is \$45 million, so long as the combined amount does not exceed \$60 million. As of February 23, 2010, UNS Gas and UNS Electric had \$45 million and \$33 million, respectively, to borrow under their revolving credit facility. From time to time, TEP, UNS Gas and UNS Electric use their respective revolving credit facilities to post collateral. If additional collateral is required, it may negatively impact TEP, UNS Gas and/or UNS Electric's ability to fund their capital requirements. As of December 31, 2009, TEP, UNS Gas and UNS Electric had posted \$1 million, \$2 million, and \$11 million, respectively, with counterparties.

**UniSource Energy and its subsidiaries have substantial debt which could adversely affect their business and results of operations.**

UniSource Energy has no operations of its own and derives all of its revenues and cash flow from its subsidiaries. At December 31, 2009, the ratio of total debt (including capital lease obligations net of investments in lease debt) to total capitalization for UniSource Energy and its subsidiaries was 70%. This substantial debt level:

- requires UniSource Energy and its subsidiaries to dedicate a substantial portion of their cash flow to pay principal and interest on their debt, which could reduce the funds available for working capital, capital expenditures, acquisitions and other general corporate purposes; and
- could limit UniSource Energy and its subsidiaries' ability to borrow additional amounts for working capital, capital expenditures, acquisitions, dividends, debt service requirements, execution of its business strategy or other purposes.

**The cost of renewing leases or purchasing TEP's leased assets, or the cost of procuring alternate sources of generation or purchased power, could adversely affect TEP's results of operations, net income and cash flows.**

TEP, under separate sale and leaseback arrangements, leases the following generation facilities:

<b>Leased Asset</b>	<b>Expiration</b>	<b>Renewal/Purchase Option</b>
Springerville Unit 1	2015	Fair market value purchase option
Springerville Coal Handling Facilities	2015	Fixed price purchase option of \$120 million
Springerville Common Facilities	2017 & 2021	Fixed price purchase option of \$106 million
Sundt Unit 4	2011	Agreement to purchase equity entered into January 2010

TEP may renew the leases or purchase the assets when the leases expire at various times between 2011 and 2021. The renewal and purchase options for Springerville Unit 1 are generally for fair market value as determined at that time, whereas fixed purchase price options exist for the coal handling and common facilities leases. Upon expiration of the coal handling and common facilities leases (whether at the end of the initial term or any renewal term), TEP has the obligation under agreements with the Springerville Units 3 and 4 owners to purchase such facilities, and each of the owners of Springerville Units 3 and 4 has the obligation to purchase or continue renting from TEP at 14% and 17% interest, respectively, in these facilities.

## **ENVIRONMENTAL**

**UniSource Energy's utility subsidiaries are subject to numerous environmental laws and regulations that may increase their cost of operations or expose them to environmentally-related litigation and liabilities.**

UniSource Energy's utility subsidiaries are subject to numerous federal, state and local environmental laws and regulations affecting present and future operations, including rules regarding air emissions, water quality, wastewater discharges, solid waste and hazardous waste. Many of these regulations arise from TEP's reliance on coal as its primary fuel for energy generation.

These laws and regulations can contribute to higher capital, operating and other costs, particularly with regard to enforcement efforts focused on existing power plants and compliance plans with regard to new and existing power plants. These laws and regulations generally require us to obtain and comply with a wide variety of environmental licenses, permits, authorizations and other approvals. Both public officials and private individuals may seek to enforce applicable environmental laws and regulations. Failure to comply with applicable laws and regulations might result in the imposition of fines and penalties by regulatory authorities. We cannot provide assurance that existing environmental laws and regulations will not be revised or that new environmental laws and regulations will not be adopted or become applicable to us. Increased compliance costs or additional operating restrictions from revised or additional regulation could have an adverse effect on our results of operations, particularly if those costs are not fully recoverable from our ratepayers.

TEP also is contractually obligated to pay a portion of the environmental reclamation costs incurred at generating stations in which it has a minority interest and may be obliged to pay similar costs at the mines that supply these generating stations. While TEP has recorded the portion of its costs that can be determined at this time, the total costs for final reclamation at these sites are unknown and could be substantial.



**New federal regulations to limit greenhouse gas emissions could increase TEP's cost of operations and result in a change in the composition of TEP's coal-dominated generating fleet.**

Based on the finding by the EPA in December 2009 stating that greenhouse gases endanger public health and welfare, the agency is in the process of developing regulations limiting greenhouse gas emissions. In addition, there are proposals and ongoing studies at the state, federal and international levels to address global climate change that could also result in the regulation of carbon dioxide (CO<sub>2</sub>) and other greenhouse gases. Any future regulatory actions taken to address global climate change represent a business risk to our operations. In 2009, 69% of TEP's total energy resources came from its coal-fueled generating facilities. Reductions in CO<sub>2</sub> emissions to the levels specified by some proposals could be materially adverse to our financial position or results of operations if associated costs of control or limitation cannot be recovered from customers. Any future legislation or regulation addressing climate change could produce a number of other results including additional costs to fund energy efficiency activities, costly modifications to, or reexamination of the economic viability of, our existing coal plants or changes in the overall fuel mix of our generating fleet. The impact of legislation or regulation to address global climate change would depend on the specific legislation or regulation enacted and cannot be determined at this time.

**UniSource Energy could be subject to physical risks associated with climate change.**

Climate change may cause physical risks, including an increase in sea level, intensified storms, water scarcity and changes in weather conditions, such as changes in precipitation, average temperatures and extreme weather conditions. A significant portion of the nation's oil and gas infrastructure is located in areas susceptible to storm damage that could be aggravated by wetland and barrier island erosion, which could give rise to fuel supply interruptions and price spikes.

These and other physical changes could result in changes in customer demand, increased costs associated with repairing and maintaining generation facilities and transmission and distribution systems resulting in increased maintenance and capital costs (and potential increased financing needs), limits on the company's ability to meet peak customer demand, increased regulatory oversight, and lower customer satisfaction. Also, to the extent that climate change adversely impacts the economic health of a region, it may adversely impact customer demand and revenues. Such physical risks could have an adverse effect on our financial condition, results of operations and liquidity.

**OPERATIONAL****The operation of electric generating stations involves risks that could result in unplanned outages or reduced generating capability that could adversely affect TEP's results of operations, net income and cash flows.**

The operation of electric generating stations involves certain risks, including equipment breakdown or failure, interruption of fuel supply and lower than expected levels of efficiency or operational performance. Unplanned outages, including extensions of planned outages due to equipment failure or other complications occur from time to time and are an inherent risk of our business. If TEP's generating stations operate below expectations, TEP could be adversely affected.

**The operation of electric transmission and distribution systems involves a risk of significant unplanned outages that could adversely affect TEP and UNS Electric's businesses, results of operations, net income and cash flows.**

The operation of electric transmission and distribution systems involves certain risks, including equipment failure and damage caused by storms, fires or other hazards. Unplanned outages occur from time to time and are an inherent risk of our business. If TEP or UNS Electric's transmission and distribution systems experience a significant failure, TEP or UNS Electric could be adversely affected.

**TEP could be subject to penalties as a result of mandatory reliability standards.**

As a result of the Energy Policy Act of 2005, owners and operators of bulk power transmission systems, including TEP, are subject to mandatory reliability standards that are developed and enforced by NERC, subject to the oversight of FERC. If we fail to comply with the mandatory reliability standards we could be subject to sanctions, including substantial monetary penalties.

**UNS Electric may not be able to secure sufficient energy resources to serve its retail customers.**

UNS Electric owns 68 MW of peaking generation resources and is purchasing the output of the 90 MW BMGS from UED through a PPA that extends through May 2013. UNS Electric also relies on short and intermediate term purchased power contracts to meet its retail energy demand. In 2009, UNS Electric's peak retail demand was 559 MW. UNS Electric procures its projected retail peak demand requirements prior to the start of the summer season. In addition to its owned resources and PPA with UED, UNS Electric has acquired other contract capacity to satisfy 90% and 60% of its projected summer peak demand for 2010 and 2011, respectively. However, UNS Electric cannot predict whether it will be able to obtain sufficient resources to meet its retail energy demand for 2010 and beyond. UNS Electric's cash flows and net income could be negatively impacted if UNS Electric is unable to secure adequate energy resources to sell to its retail customers.

**TEP or UNS Electric may not be able to secure adequate right-of-way to construct transmission lines and may be required to find alternate ways to provide adequate sources of energy and maintain reliability in TEP and UNS Electric's service areas.**

TEP and UNS Electric rely on federal, state and local governmental agencies to secure right-of-way and siting permits to construct transmission lines. If adequate right-of-way and siting permits to build new transmission lines cannot be secured:

- TEP and UNS Electric may need to rely on more costly alternatives to provide energy to their customers;
- TEP and UNS Electric may not be able to maintain reliability in their service areas; or
- TEP and UNS Electric's ability to provide electric service to new customers may be negatively impacted.

**TEP may be required to build an estimated \$120 million transmission line from Tucson to Nogales or UNS Electric or TEP may be required to find alternate ways to improve reliability in UNS Electric's Santa Cruz service area.**

In 2001, TEP entered into an agreement to build an approximately 60-mile transmission line from Tucson to Nogales, Arizona, in response to an order from the ACC to improve reliability to UNS Electric's retail customers in Nogales. Required regulatory approvals have delayed the construction of the transmission line, and in 2005, the ACC initiated proceedings to review the status of service in Nogales and need for the 345-kV line. After a hearing on the issue in February 2006, the ACC directed the ALJ to amend the recommendation to direct the Arizona Power Plant and Transmission Line Siting Committee to gather facts related to options for improving service reliability in Santa Cruz County. If all regulatory approvals are received and the project moves forward, the future costs to construct the transmission line from Tucson to Nogales are expected to be \$120 million. If TEP is required to build the transmission line, it may negatively impact TEP's ability to internally fund substantially all of its capital requirements.

If TEP does not receive required approvals or if the project is abandoned, TEP may be required to expense a portion of the \$11 million it has incurred through December 31, 2009, in land acquisition, engineering and environmental expenses. In such an event, TEP or UNS Electric may be required to make additional expenditures to improve reliability. In the event TEP or UNS Electric are unable to recover such expenditures, their results of operations and net income could be adversely affected.

**ITEM 1B. — UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2. — PROPERTIES****TEP PROPERTIES**

TEP's transmission facilities, located in Arizona and New Mexico, transmit electricity from TEP's remote electric generating stations at Four Corners, Navajo, San Juan, Springerville and Luna to the Tucson area for use by TEP's retail customers (see *Item 1. — Business — Generating and Other Resources*). The transmission system is interconnected at various points in Arizona and New Mexico with a number of regional utilities. TEP has arrangements with approximately 120 companies to interchange generation capacity and transmission of energy.

As of December 31, 2009, TEP owned or participated in an overhead electric transmission and distribution system consisting of:

- 512 circuit-miles of 500-kV lines;
- 1,087 circuit-miles of 345-kV lines;
- 369 circuit-miles of 138-kV lines;
- 477 circuit-miles of 46-kV lines; and
- 2,622 circuit-miles of lower voltage primary lines.

The underground electric distribution system is comprised of 4,341 cable-miles. TEP owns approximately 76% of the poles on which the lower voltage lines are located. Electric substation capacity consisted of 102 substations with a total installed transformer capacity of 13,170,650 kilovolt amperes.

Substantially all of the utility assets owned by TEP are subject to the lien of the 1992 Mortgage. Springerville Unit 2, which is owned by San Carlos Resources Inc., a wholly-owned subsidiary of TEP (San Carlos), is not subject to the lien.

The electric generating stations (except as noted below), operating headquarters, warehouse and service center are located on land owned by TEP. The electric distribution and transmission facilities owned by TEP are located:

- on property owned by TEP;
- under or over streets, alleys, highways and other public places, the public domain and national forests and state lands under franchises, easements or other rights which are generally subject to termination;
- under or over private property as a result of easements obtained primarily from the record holder of title; or
- over American Indian reservations under grant of easement by the Secretary of Interior or lease by American Indian tribes.

It is possible that some of the easements, and the property over which the easements were granted, may have title defects or may be subject to mortgages or liens existing at the time the easements were acquired.

Springerville is located on land parcels held by TEP under a long-term surface ownership agreement with the State of Arizona.

Four Corners and Navajo are located on properties held under easements from the United States and under leases from the Navajo Nation, respectively. TEP, individually and in conjunction with PNM in connection with San Juan, has acquired easements and leases for transmission lines and a water diversion facility located on land owned by the Navajo Nation. TEP has also acquired easements for transmission facilities, related to San Juan, Four Corners, and Navajo, across the Zuni, Navajo and Tohono O'odham Indian Reservations. TEP, in conjunction with PNM and Phelps Dodge, holds an undivided ownership interest in the property on which Luna is located.

TEP's rights under these various easements and leases may be subject to defects such as:

- possible conflicting grants or encumbrances due to the absence of or inadequacies in the recording laws or record systems of the Bureau of Indian Affairs and the American Indian tribes;
- possible inability of TEP to legally enforce its rights against adverse claimants and the American Indian tribes without Congressional consent; or
- failure or inability of the American Indian tribes to protect TEP's interests in the easements and leases from disruption by the U.S. Congress, Secretary of the Interior, or other adverse claimants.

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These possible defects have not interfered and are not expected to materially interfere with TEP's interest in and operation of its facilities.

TEP, under separate sale and leaseback arrangements, leases the following generation facilities (which do not include land):

- coal handling facilities at Springerville;
- a 50% undivided interest in the Springerville Common Facilities;
- Springerville Unit 1 and the remaining 50% undivided interest in the Springerville Common Facilities; and
- Sundt Unit 4 and related common facilities.

See Note 6 of Notes to Consolidated Financial Statements, Debt, Credit Facilities, and Capital Lease Obligations and Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, Tucson Electric Power Company, Liquidity and Capital Resources, Contractual Obligations, for additional information on TEP's capital lease obligations.

## **UES PROPERTIES**

### **UNS Gas**

As of December 31, 2009, UNS Gas' transmission and distribution system consisted of approximately 58 miles of steel transmission mains, 4,173 miles of steel and plastic distribution mains, and 135,920 customer service lines.

### **UNS Electric**

As of December 31, 2009, UNS Electric's transmission and distribution system consisted of approximately 56 circuit-miles of 115-kV transmission lines, 264 circuit-miles of 69-kV transmission lines, and 3,581 circuit-miles of underground and overhead distribution lines. UNS Electric also owns 39 substations having a total installed capacity of 1,768,050 kilovolt amperes and the 65 MW Valencia plant.

The gas and electric distribution and transmission facilities owned by UNS Gas and UNS Electric are located:

- on property owned by UNS Gas or UNS Electric;
- under or over streets, alleys, highways and other public places, the public domain and national forests and state lands under franchises, easements or other rights which are generally subject to termination; or
- under or over private property as a result of easements obtained primarily from the record holder of title.

It is possible that some of the easements, and the property over which the easements were granted, may have title defects or may be subject to mortgages or liens existing at the time the easements were acquired.

## **UED PROPERTIES**

As of December 31, 2009, UED owned a 90 MW gas-fired generation facility in Kingman, Arizona, known as BMGS, that was completed in May 2008. BMGS is located on property that is owned by UNS Electric and currently leased to UED. BMGS is subject to a lien to secure UED's obligations under its term loan facility.

## **ITEM 3. — LEGAL PROCEEDINGS**

### **Right of Way Matters**

TEP is a defendant in a putative class action filed on February 11, 2009, in the United States District Court in Albuquerque, New Mexico by members of the Navajo Nation. The plaintiffs allege, among other things, that the rights of ways for defendants' transmission lines on Navajo lands were improperly granted and that the compensation paid for such rights of way was inadequate. The plaintiffs are requesting, among other things, that the transmission lines on these lands be removed. In June 2009, TEP and the other defendants filed motions to dismiss the lawsuit on procedural grounds and in September 2009, the plaintiffs filed responses. TEP cannot predict the outcome of this lawsuit.



**Sierra Club San Juan Allegations**

In December 2009, the Sierra Club sent TEP, the other owners of the San Juan Generating Station (SJGS), and San Juan Coal Company (SJCC), a Notice of Intent to Sue (RCRA Notice) under the Resource Conservation and Recovery Act (RCRA). The RCRA Notice alleges that certain activities at SJGS and the San Juan mine associated with the treatment, storage and disposal of coal and coal combustion by-products (CCBs) are causing imminent and substantial harm to the environment and that placement of CCBs at the mine constitute "open dumping" in violation of RCRA. Additionally, TEP has been informed that the Sierra Club sent SJCC a separate Notice of Intent to Sue (SMCRA Notice) under the Surface Mine Control and Reclamation Act (SMCRA) in December 2009. The SMCRA Notice similarly alleges damage to the environment due to activities at the San Juan mine, including the placement of CCBs from SJGS in the surface pits at the mine. Both Notices state Sierra Club's intent to file citizens' suits to pursue these claims upon expiration of the RCRA and SMRCA statutory notice periods. If suits are filed, potential remedies include the imposition of civil penalties and injunctive relief. TEP and Public Service Company of New Mexico, the SJGS operator, plan an aggressive defense of the RCRA claims. TEP cannot predict the outcome of these matters at this time.

See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, Tucson Electric Power Company, Factors Affecting Operations*, for litigation related to ACC orders and retail competition.

In addition, see legal proceedings described in Note 4 of *Notes to Consolidated Financial Statements, Commitments and Contingencies*.

**ITEM 4. — SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Not applicable.

**PART II****ITEM 5. — MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF COMMON EQUITY****Stock Trading**

UniSource Energy's Common Stock is traded under the ticker symbol UNS and is listed on the New York Stock Exchange. On February 23, 2010, the closing price was \$31.37, with 9,375 shareholders of record.

**Dividends**

UniSource Energy's Board of Directors currently expects to continue to pay regular quarterly cash dividends on our Common Stock subject, however, to the Board's evaluation of our financial condition, earnings, cash flows and dividend policy.

UniSource Energy is the sole shareholder of TEP's common stock and relies on dividends from its subsidiaries, primarily TEP, to declare and pay dividends. The TEP Board of Directors typically declares a dividend at the end of each year.

See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, UniSource Energy Consolidated, Liquidity and Capital Resources, Dividends on Common Stock*.

**Common Stock Dividends and Price Ranges**

Quarter:	2009			2008		
	Market Price per Share of Common Stock <sup>(1)</sup>		Dividends Declared	Market Price per Share of Common Stock <sup>(1)</sup>		Dividends Declared
	High	Low		High	Low	
First	\$ 29.97	\$ 22.76	\$ 0.29	\$ 32.18	\$ 21.35	\$ 0.24
Second	28.76	24.78	0.29	34.49	22.33	0.24
Third	31.11	25.96	0.29	33.42	28.10	0.24
Fourth	33.11	28.04	0.29	29.67	20.91	0.24
Total			\$ 1.16			\$ 0.96

(1) UniSource Energy's Common Stock price as reported by the New York Stock Exchange.

On February 12, 2010, UniSource Energy declared a cash dividend of \$0.39 per share on its Common Stock. The dividend will be paid March 8, 2010 to shareholders of record at the close of business February 23, 2010.

TEP's common stock is wholly-owned by UniSource Energy and is not listed for trading on any stock exchange. TEP declared and paid cash dividends to UniSource Energy of \$60 million in 2009, \$3 million in 2008, and \$53 million in 2007.

**Convertible Senior Notes**

In 2005, UniSource Energy issued \$150 million of 4.50% Convertible Senior Notes due 2035. Each \$1,000 of Convertible Senior Notes is convertible into 27.427 shares of our Common Stock at any time, representing a conversion price of approximately \$36.46 per share of our Common Stock, subject to adjustment in certain circumstances. See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, UniSource Energy Consolidated, Liquidity and Capital Resources, Executive Overview, UniSource Energy Consolidated Cash Flows, Financing Activities.*

**Issuer Purchases of Common Equity**

UniSource Energy did not purchase any of its Common Stock during 2009, 2008 or 2007.

## ITEM 6. — SELECTED CONSOLIDATED FINANCIAL DATA

## UniSource Energy

	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
	- In Thousands - (except per share data)				
<b>Summary of Operations</b>					
Operating Revenues	\$ 1,394,424	\$ 1,397,511	\$ 1,381,373	\$ 1,308,141	\$ 1,224,056
Income Before Discontinued Operations and Accounting Change	\$ 104,258	\$ 14,021	\$ 58,373	\$ 69,243	\$ 52,253
Net Income <sup>(1)</sup>	\$ 104,258	\$ 14,021	\$ 58,373	\$ 67,447	\$ 46,144
<b>Basic Earnings per Share:</b>					
Before Discontinued Operations & Accounting Change	\$ 2.91	\$ 0.39	\$ 1.64	\$ 1.96	\$ 1.51
Net Income	\$ 2.91	\$ 0.39	\$ 1.64	\$ 1.91	\$ 1.33
<b>Diluted Earnings per Share:</b>					
Before Discontinued Operations & Accounting Change	\$ 2.69	\$ 0.39	\$ 1.57	\$ 1.85	\$ 1.44
Net Income	\$ 2.69	\$ 0.39	\$ 1.57	\$ 1.80	\$ 1.28
<b>Shares of Common Stock Outstanding</b>					
Average	35,858	35,632	35,486	35,264	34,798
End of Year	35,851	35,458	35,315	35,190	34,874
Year-end Book Value per Share	\$ 20.94	\$ 19.16	\$ 19.54	\$ 18.59	\$ 17.69
Cash Dividends Declared per Share	\$ 1.16	\$ 0.96	\$ 0.90	\$ 0.84	\$ 0.76
<b>Financial Position</b>					
Total Utility Plant — Net	\$ 2,785,714	\$ 2,617,693	\$ 2,407,295	\$ 2,259,620	\$ 2,171,461
Investments in Lease Debt and Equity	132,168	126,672	152,544	181,222	156,301
Other Investments and Other Property	60,239	64,096	70,677	66,194	58,468
Total Assets	\$ 3,601,242	\$ 3,509,567	\$ 3,185,716	\$ 3,187,409	\$ 3,180,211
Long-Term Debt	\$ 1,307,795	\$ 1,313,615	\$ 993,870	\$ 1,171,170	\$ 1,212,420
Non-Current Capital Lease Obligations	488,349	513,517	530,973	588,771	665,737
Common Stock Equity	750,865	679,274	690,075	654,149	616,741
Total Capitalization	\$ 2,547,009	\$ 2,506,406	\$ 2,214,918	\$ 2,414,090	\$ 2,494,898
<b>Selected Cash Flow Data</b>					
Net Cash Flows From Operating Activities	\$ 347,310	\$ 277,011	\$ 322,766	\$ 282,659	\$ 273,883
Capital Expenditures	\$ (287,104)	\$ (357,324)	\$ (245,366)	\$ (238,261)	\$ (203,362)
Other Investing Cash Flows <sup>(2)</sup>	(9,540)	(95,493)	27,961	(7,820)	32,794
Net Cash Flows From Investing Activities	\$ (296,644)	\$ (452,817)	\$ (217,405)	\$ (246,081)	\$ (170,568)
Net Cash Flows From Financing Activities	\$ (28,916)	\$ 140,605	\$ (119,229)	\$ (77,016)	\$ (112,664)
<b>Ratio of Earnings to Fixed Charges <sup>(3)</sup></b>					
	2.47	1.24	1.68	1.73	1.55

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- (1) Net Income includes an after-tax loss for discontinued operations of \$2 million in 2006, and \$5 million in 2005. Net income includes an after-tax loss of \$0.6 million for the Cumulative Effect of Accounting Change from the implementation of asset retirement accounting in 2005.
- (2) Other Investing Cash Flows in 2008 includes the \$133 million deposit to Trustee for Repayment of Collateral Trust Bond.
- (3) For purposes of this computation, earnings are defined as pre-tax earnings from continuing operations before minority interest, or income/loss from equity method investments, 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.

See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations*.

## TEP

	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
	-Thousands of Dollars-				
<b>Summary of Operations</b>					
Operating Revenues	<b>\$1,096,711</b>	\$1,079,253	\$1,070,503	\$ 988,994	\$ 937,470
Income Before Accounting Change	<b>89,248</b>	4,363	53,456	66,745	48,893
Net Income <sup>(1)</sup>	<b>\$ 89,248</b>	\$ 4,363	\$ 53,456	\$ 66,745	\$ 48,267
<b>Financial Position</b>					
Total Utility Plant — Net	<b>\$2,261,325</b>	\$2,120,619	\$1,957,506	\$1,887,387	\$1,866,622
Investments in Lease Debt and Equity	<b>132,168</b>	126,672	152,544	181,222	156,301
Other Investments and Other Property	<b>31,813</b>	31,291	35,460	30,161	27,013
Total Assets	<b>\$2,914,299</b>	\$2,841,771	\$2,573,036	\$2,623,063	\$2,617,219
Long-Term Debt	<b>\$ 903,615</b>	\$ 903,615	\$ 682,870	\$ 821,170	\$ 821,170
Non-Current Capital Lease Obligations	<b>488,311</b>	513,370	530,714	588,424	665,299
Common Stock Equity	<b>643,144</b>	583,606	577,349	554,714	558,646
Total Capitalization	<b>\$2,035,070</b>	\$2,000,591	\$1,790,933	\$1,964,308	\$2,045,115
<b>Selected Cash Flow Data</b>					
Net Cash Flows From Operating Activities	<b>\$ 268,064</b>	\$ 268,706	\$ 264,112	\$ 227,228	\$ 243,013
Capital Expenditures	<b>\$ (235,485)</b>	\$ (294,940)	\$ (162,539)	\$ (156,180)	\$ (149,906)
Other Investing Cash Flows <sup>(2)</sup>	<b>(14,116)</b>	(95,814)	25,414	(25,786)	21,001
Net Cash Flows From Investing Activities	<b>\$ (249,601)</b>	\$ (390,754)	\$ (137,125)	\$ (181,966)	\$ (128,905)
Net Cash Flows From Financing Activities	<b>\$ (29,320)</b>	\$ 128,713	\$ (120,088)	\$ (78,984)	\$ (173,882)
<b>Ratio of Earnings to Fixed Charges <sup>(3)</sup></b>	<b>2.58</b>	1.13	1.75	1.84	1.60

- (1) Net Income includes an after-tax loss of \$0.6 million for the Cumulative Effect of Accounting Change from the implementation of asset retirement accounting in 2005.
- (2) Other Investing Cash Flows in 2008 includes the \$133 million deposit to Trustee for Repayment of Collateral Trust Bonds.
- (3) For purposes of this computation, earnings are defined as pre-tax earnings from continuing operations before minority interest, or income/loss from equity method investments, 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.

Note: Disclosure of earnings per share information for TEP is not presented as the common stock of TEP is not publicly traded.

See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations*.



**ITEM 7. — 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 and its three primary business segments and includes the following:

- outlook and strategies,
- operating results during 2009 compared with 2008, and 2008 compared with 2007,
- factors which affect our results and outlook,
- liquidity, capital needs, capital resources, and contractual obligations,
- dividends, and
- critical accounting policies.

UniSource Energy is a holding company that has no significant operations of its own. Operations are conducted by UniSource Energy's subsidiaries, each of which is a separate legal entity with its own assets and liabilities. UniSource Energy owns the outstanding common stock of TEP, UniSource Energy Services, Inc. (UES), UniSource Energy Development Company (UED) and Millennium Energy Holdings, Inc. (Millennium).

TEP, an electric utility, provides electric service to the community of Tucson, Arizona. UES, through its two operating subsidiaries, UNS Gas, Inc. (UNS Gas) and UNS Electric, Inc. (UNS Electric), provides gas and electric service to 30 communities in Northern and Southern Arizona. UED developed and owns the Black Mountain Generating Station (BMGS), a gas turbine project in Northern Arizona that provides energy to UNS Electric through a five-year power sale agreement. Millennium has existing investments in unregulated businesses; however no new investments are planned at Millennium. We conduct our business in three primary business segments — TEP, UNS Gas and UNS Electric.

At December 31, 2009, the investment in Millennium represented 1% of UniSource Energy's total assets.

**UNISOURCE ENERGY CONSOLIDATED****OUTLOOK AND STRATEGIES**

Our financial prospects and outlook for the next few years will be affected by many factors including: TEP's 2008 Rate Order that freezes base rates through 2012, the recent national and regional economic downturn, the financial market disruptions and volatility, potential regulations impacting greenhouse gas emissions and other regulatory factors. Our plans and strategies include the following:

- Develop strategic responses to potential new legislation on carbon emissions, including the evaluation of TEP's existing mix of generation resources, and define steps to achieve environmental objectives that provide an appropriate return on investment and are consistent with earnings growth;
- Obtain ACC approval of rate increases for UNS Gas and UNS Electric to provide adequate revenues to cover the rising cost of providing reliable and safe service to their customers;
- Expand TEP and UNS Electric's transmission system to meet increasing loads and provide access to renewable energy resources;
- Expand TEP and UNS Electric's portfolio of renewable energy sources and programs to meet Arizona's renewable energy standards;
- Create future ownership opportunities for renewable energy projects; and
- Ensure UniSource Energy continues to have adequate liquidity by maintaining sufficient lines of credit and regularly reviewing and adjusting UniSource Energy's short-term investment strategies in response to market conditions.

## Economic Conditions

### Sales and Revenues

As a result of general economic conditions, retail customer growth and energy usage by residential and commercial customers at UniSource Energy's utility subsidiaries is below the average levels experienced in prior periods. From 2003 to 2007, the growth in number of customers in UniSource Energy's utility service territories averaged 2% per year for TEP, and 3% per year for UNS Gas and UNS Electric. During 2008 and 2009, UniSource Energy's results were impacted by slower retail customer growth and lower energy consumption.

TEP and UES experienced retail customer growth of less than 1% during 2009. TEP's total retail kWh sales decreased by 1.4% in 2008 compared with 2007. This was the first year-over-year decrease in TEP's retail kWh sales since 2002. In 2009, TEP's kWh sales declined by 1.4% over the prior year's levels. This compares with average annual increases in retail kWh sales of 4% from 2003 to 2007. We did not experience a significant increase in uncollectible accounts at TEP, UNS Gas or UNS Electric in 2008 or 2009.

UniSource Energy's future results of operations may continue to be impacted by weak economic conditions. We cannot predict if the customer growth rate or sales volumes will return to historic levels. We expect TEP's customer base to grow at a rate of less than 1% in 2010 and approximately 1% in 2011. UES' customer base is expected to grow at a rate of less than 1% in 2010 and 2011.

### Financial Markets

To date, UniSource Energy and its subsidiaries have not been materially impacted by volatility and disruptions in the financial markets. Our banking relationships remain stable. UniSource Energy and its subsidiaries have access to \$280 million of revolving credit facilities, of which \$202 million was unused as of February 23, 2010, which we believe is sufficient to meet current operating, capital and financing needs. UniSource Energy, TEP, UNS Gas and UNS Electric have not experienced, nor do they expect to experience, any difficulties obtaining funding under their respective revolving credit facilities. None of these credit facilities have any bankrupt financial institutions as lenders, and no lenders in the bank groups have refused to fund when requested.

UniSource Energy and its subsidiaries are also subject to interest rate risk on variable rate revolving credit facility borrowings and outstanding long-term variable rate debt. See *Liquidity and Capital Resources, Interest Rate Risk; Tucson Electric Power, Liquidity and Capital Resources, Interest Rate Risk; UNS Gas, Liquidity and Capital Resources, Interest Rate Risk; and UNS Electric, Liquidity and Capital Resources, Interest Rate Risk* below.

Neither UniSource Energy nor any of its subsidiaries have any scheduled long-term debt maturities until 2011 when \$50 million of unsecured notes mature at UNS Gas. The UniSource Energy and TEP Credit Agreements and the UNS Gas/UNS Electric Revolver also expire in 2011. UniSource Energy is required to make principal payments on an amortizing term loan, totaling \$6 million per year. See *UniSource Energy Credit Agreement*, below.

As of February 23, 2010, TEP, UNS Electric and UNS Gas did not have any material power or gas trading exposure to financially distressed counterparties. We cannot predict whether in the future our financial condition or results of operations will be impacted by current economic conditions or liquidity concerns in the financial markets. See *Liquidity and Capital Resources*, below.

### Pension and Post-Retirement Benefits

TEP, UNS Gas and UNS Electric maintain noncontributory, defined benefit pension plans for substantially all regular employees and certain affiliate employees. Benefits are based on years of service and the employee's average compensation. TEP, UNS Gas and UNS Electric fund the plans by contributing at least the minimum amount required under Internal Revenue Service regulations. Additionally, we provide supplemental retirement benefits to certain employees whose benefits are limited by Internal Revenue Service benefit or compensation limitations.

The pension assets are invested in a diversified portfolio of domestic and international equity securities, fixed income securities, real estate and alternative investments. As of December 31, 2009, the total value of the pension assets was approximately \$184 million, compared with \$135 million as of December 31, 2008. Our accumulated benefit obligation at December 31, 2009 and at December 31, 2008 was \$210 million and \$198 million, respectively. Due to the increase in the plan total asset value during 2009, projected funding levels are expected to be \$22 million in 2010, compared with the \$23 million contribution that was funded in 2009.

### **Environmental Matters**

UniSource Energy's utility subsidiaries are subject to numerous federal, state and local environmental laws and regulations affecting present and future operations, including regulations regarding air emissions, water quality, wastewater discharges, solid waste and hazardous waste.

These laws and regulations can result in increased capital, operating and other costs, particularly with regard to enforcement efforts focused on existing power plants and compliance plans with regard to new and existing power plants. There are proposals and ongoing studies at the state, federal and international levels to address global climate change that could result in the regulation of CO<sub>2</sub> and other greenhouse gases. Such legislation or regulation could produce a number of results including additional costs to fund energy efficiency activities, costly modifications to, or reexamination of the economic viability of, our existing coal plants or changes in the overall fuel mix of our generating fleet. The impact of legislation or regulation to address global climate change would depend on the specific legislation or regulation enacted and cannot be determined at this time. For further discussion of the possible impact of environmental matters on our business, see *Item 1. Business -Environmental Matters and Item 1A. Risk Factors*.

## **RESULTS OF OPERATIONS**

### **Executive Overview**

UniSource Energy recorded Net Income of \$104 million in 2009, \$14 million in 2008 and \$58 million in 2007.

#### 2009 Compared with 2008

The increase in UniSource Energy's net income in 2009 is due primarily to three factors: 1) a \$40 million increase in TEP's retail revenues (excluding revenues collected from customers for renewable energy and energy efficiency programs) resulting from a 6% base rate increase and hot summer weather during the third quarter of 2009; 2) a \$30 million decrease in total fuel and purchased energy expense (net of short-term wholesale revenues); and 3) \$50 million of regulatory expenses, revenue deferrals and accounting adjustments in 2008 that did not recur in 2009. Other factors include a \$6 million pre-tax gain recorded in 2009 resulting from Millennium's sale of an investment. See *Tucson Electric Power Company, Results of Operations*, below.

#### 2008 Compared with 2007

UniSource Energy recorded net income of \$14 million in 2008 compared with net income of \$58 million in 2007. The decrease in UniSource Energy's net income in 2008 was due primarily to higher costs at TEP and the impacts resulting from the 2008 TEP Rate Order. TEP incurred higher coal-related fuel expense; higher purchased power costs due partially to plant outages in the first and third quarters of 2008; and higher operations and maintenance (O&M) expense primarily due to generating plant maintenance.

Results in 2008 were also impacted by: a \$54 million decrease in TRA amortization; the 2008 TEP Rate Order that included a credit to retail customers that decreased revenue by \$58 million; and adjustments that reduced pre-tax expenses by \$32 million related to the reapplication of regulatory accounting to TEP's generating assets, resulting from the 2008 TEP Rate Order. See *Tucson Electric Power Company, Results of Operations*, below.

## O&M

The table below summarizes the items included in UniSource Energy's O&M expense.

	2009	2008	2007
	-Millions of Dollars-		
TEP Base O&M	\$ 231	\$ 219	\$ 192
UNS Gas Base O&M	25	25	27
UNS Electric Base O&M	21	21	23
Base Utility O&M	277	265	242
Consolidating Adjustments and Other <sup>(1)</sup>	(7)	(7)	(11)
UniSource Energy Base O&M	270	258	231
Reimbursed Expenses Related to Springerville Units 3 and 4	41	35	24
Gain on the Sale of SO <sub>2</sub> Emissions Allowances	—	(1)	(15)
Expenses related to customer-funded renewable energy programs <sup>(2)</sup>	23	5	2
Reinstatement of Regulatory Accounting	—	(1)	—
<b>Total UniSource Energy O&amp;M</b>	<b>\$ 334</b>	<b>\$ 296</b>	<b>\$ 242</b>

<sup>(1)</sup> Includes Millennium, UED and parent company O&M, and inter-company eliminations

<sup>(2)</sup> Represents expenses related to customer-funded renewable energy programs; the offsetting funds collected from customers are recorded in other revenue.

## CONTRIBUTION BY BUSINESS SEGMENT

The table below shows the contributions to our consolidated after-tax earnings by our three business segments and Other net income (loss).

	2009	2008	2007
	-Millions of Dollars-		
TEP	\$ 89	\$ 4	\$ 53
UNS Gas	7	9	4
UNS Electric	6	4	5
Other <sup>(1)</sup>	2	(3)	(4)
<b>Consolidated Net Income</b>	<b>\$ 104</b>	<b>\$ 14</b>	<b>\$ 58</b>

<sup>(1)</sup> Includes: UniSource Energy parent company expenses; UniSource Energy parent company interest expense (net of tax) on the UniSource Energy Convertible Senior Notes and on the UniSource Energy Credit Agreement; and income and losses from Millennium investments and UED.

## LIQUIDITY AND CAPITAL RESOURCES

### Liquidity

The primary source of liquidity for UniSource Energy, the parent company, is dividends from its subsidiaries, primarily TEP. Also, under UniSource Energy's tax sharing agreement, subsidiaries make income tax payments to UniSource Energy, which makes payments on behalf of the consolidated group. The table below provides a summary of the liquidity position of UniSource Energy on a stand-alone basis and each of its segments.

<b>Balances As of February 23, 2010</b>	<b>Cash and Cash Equivalents</b>	<b>Borrowings under Revolving Credit Facility <sup>(3)</sup></b>	<b>Amount Available under Revolving Credit Facility</b>
		-Millions of Dollars-	
UniSource Energy stand-alone	\$ 2	\$ 15	\$ 55
TEP	26	51	99
UNS Gas	41	—	45 <sup>(1)</sup>
UNS Electric	6	12	33 <sup>(1)</sup>
Other	8 <sup>(2)</sup>	N/A	N/A
Total	<u>\$ 83</u>		

(1) Currently, either UNS Gas or UNS Electric may borrow up to a maximum of \$45 million, but the total combined amount borrowed cannot exceed \$60 million.

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

(3) Includes LOCs issued under Revolving Credit Facilities

#### Short-term Investments

UniSource Energy has a short-term investment policy which governs the investment of excess cash balances by UniSource Energy and its subsidiaries. We review this policy periodically in response to market conditions to adjust, if necessary, the maturities and concentrations by investment type and issuer in the investment portfolio. As of December 31, 2009, UniSource Energy's short-term investments include highly-rated and liquid money market funds, certificates of deposit and commercial paper. These short-term investments are classified as Cash and Cash Equivalents on the Balance Sheet.

#### Access to Revolving Credit Facilities

UniSource Energy, TEP, UNS Gas and UNS Electric are each party to a revolving credit agreement with a group of lenders, which is available to be used for working capital purposes. Each of these agreements is a committed facility and expires in August 2011. The TEP and UNS Gas/UNS Electric Credit Agreements 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 power or gas procurement and hedging activities. The UniSource Energy Credit Agreement may be used only for revolver borrowings.

UniSource Energy and its subsidiaries believe that they have sufficient liquidity under their revolving credit facilities to meet their short-term working capital needs and to provide credit enhancement as may be required under their respective energy procurement and hedging agreements. See Item 7A. *Quantitative and Qualitative Disclosures about Market Risk, Credit Risk*, below.

#### Liquidity Outlook

Neither UniSource Energy nor any of its subsidiaries have any long-term debt maturities until 2011 when \$50 million of unsecured notes mature at UNS Gas. The UniSource Energy and TEP Credit Agreements and the UNS Gas/UNS Electric Revolver also expire in 2011. UniSource Energy is required to make principal payments on an amortizing term loan, totaling \$6 million per year. See *UniSource Energy Credit Agreement*, below.

#### **Executive Overview — UniSource Energy Consolidated Cash Flows**

	<u>2009</u>	<u>2008</u>	<u>2007</u>
	-Millions of Dollars-		
Cash provided by (used in):			
Operating Activities	\$ 347	\$ 277	\$ 323
Investing Activities	(297)	(453)	(217)
Financing Activities	(29)	141	(119)

UniSource Energy's consolidated cash flows are provided primarily from 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. As a result of the varied seasonal cash flow, UniSource Energy, TEP, UNS Gas and UNS Electric use, as needed, their revolving credit facilities to fund their business activities.



Cash used for investing activities is primarily a result of capital expenditures at TEP, UNS Gas and UNS Electric. 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.

#### Operating Activities

In 2009, net cash flows from operating activities were \$70 million higher than 2008 primarily due to: lower costs of fuel and purchased energy; increased retail revenues due to base rate increases at TEP and UNS Electric and hot summer weather; lower interest paid on capital leases and long-term debt; partially offset by lower wholesale sales, higher O&M and higher wages paid.

#### Investing Activities

Net cash used for investing activities was \$156 million lower in 2009 compared with 2008 due to: a \$133 million deposit made by TEP last year with the trustee for bonds that matured on August 1, 2008; and a \$70 million decrease in capital expenditures in 2009; partially offset by a \$31 million investment made by TEP in 2009 to purchase Springerville lease debt; and a \$12 million decrease in proceeds from investment in lease debt.

#### Capital Expenditures

<b>Business Segment</b>	<b>Actual</b>		<b>Estimated</b>			
	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>
	-Millions of Dollars-					
TEP	\$ 235	\$ 258	\$ 217	\$ 203	\$ 225	\$ 209
UNS Gas	14	14	16	16	16	18
UNS Electric	28	26	25	31	13	16
UniSource Energy Stand-Alone	10	16	27	1	—	1
<b>UniSource Energy Consolidated</b>	<b>\$ 287</b>	<b>\$ 314</b>	<b>\$ 285</b>	<b>\$ 251</b>	<b>\$ 254</b>	<b>\$ 244</b>

- Included in TEP's capital expenditures forecast for 2010 is \$52 million for the proposed purchase of Sundt Unit 4.
- Items excluded from TEP's capital expenditures forecast are: the estimated cost to construct proposed Tucson to Nogales, Arizona transmission line of \$120 million; estimated costs of \$300 million between 2011-2014 to construct 75 to 150 MW of local generation that may be required in 2015.
- The estimated capital expenditures for UniSource Energy Stand-Alone are for the purchase of land and construction of a new corporate headquarters.

For more information see *TEP, Liquidity and Capital Resources, Investing Activities, Capital Expenditures*, below, and *Item 1. Business, TEP, Transmission Access, Tucson to Nogales Transmission Line*, above.

#### Financing Activities

Net cash proceeds from financing activities were \$170 million lower in 2009 compared with 2008. In 2008, The Industrial Development Authority of Pima County issued, for the benefit of TEP, approximately \$221 million of tax-exempt industrial development revenue bonds and UNS Electric issued \$100 million of long-term debt used in part to refinance a \$60 million debt maturity. Factors affecting proceeds from financing activities in 2009 included: \$30 million of proceeds from the issuance of short-term debt at UED; a \$70 million decrease in payments of long-term debt compared with 2008; a \$50 million decline in payments on capital lease obligations compared with 2008; and a \$7 million increase in dividends paid compared with 2008.

### Capital Contributions

In March 2009, UED used loan proceeds to distribute \$30 million to UniSource Energy. UniSource Energy used the proceeds to contribute \$30 million of capital to TEP. TEP used the proceeds to purchase lease debt related to Springerville Unit 1. In February 2010, UED distributed \$9 million to UniSource Energy. See *Other Non-Reportable Business Segments, UED and Tucson Electric Power Company, Liquidity and Capital Resources*, below for more information.

In 2008, UniSource Energy contributed \$59 million in capital to UED by canceling an intercompany promissory note in the amount of \$59 million. Borrowings under the promissory note were used to finance the development of BMGS.

### **UniSource Energy Credit Agreement**

The UniSource Credit Agreement consists of a \$30 million amortizing term loan facility and a \$70 million revolving credit facility and matures in August 2011. Principal payments of \$1.5 million on the outstanding term loan are due quarterly, with the balance due at maturity. At December 31, 2009, there was \$9 million outstanding under the term loan facility and \$31 million outstanding under the UniSource Energy revolving credit facility at a weighted average interest rate of 1.48%. We have the option of paying interest on the term loan and on borrowings under the revolving credit facility at adjusted LIBOR plus 1.25% or the sum of the greater of the federal funds rate plus 0.5% or the agent bank's reference rate and 0.25%.

The UniSource Credit Agreement restricts additional indebtedness, liens, mergers, dividends, sales of assets, and certain investments and acquisitions. We must also meet: (1) a minimum cash flow to debt service coverage ratio for UniSource Energy on a stand alone basis and (2) a maximum leverage ratio on a consolidated basis. We may pay dividends if, after giving effect to the dividend payment, we have more than \$15 million of unrestricted cash and unused revolving credit.

In September 2008 and February 2009, as a result of higher than expected fuel and purchased power costs, UniSource Energy amended its credit agreements to provide more flexibility to meet the required leverage ratio. Although fuel and purchase power expenses have decreased in recent months, current economic conditions could result in lower customer growth rates and lower sales and could impact our ability to comply with these covenants.

As of December 31, 2009, we were in compliance with the terms of the UniSource Credit Agreement.

If an event of default occurs, the UniSource Credit Agreement may become immediately due and payable. An event of default includes failure to make required payments under the UniSource Credit Agreement, failure of UniSource Energy or certain subsidiaries to make payments or default on debt greater than \$20 million, or certain bankruptcy events at UniSource Energy or certain subsidiaries.

### 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. Given the recent volatility in LIBOR and other benchmark interest rates, UniSource Energy may be required to pay higher rates of interest on borrowings under its revolving credit facility. See *Item 7A. Quantitative and Qualitative Disclosures about Market Risk, Credit Risk*, below.

### Convertible Senior Notes

UniSource Energy has \$150 million of 4.50% Convertible Senior Notes due 2035. Each \$1,000 of Convertible Senior Notes is convertible into 27.427 shares of UniSource Energy Common Stock at any time, representing a conversion price of approximately \$36.46 per share of our Common Stock, subject to adjustments. The closing price of UniSource Energy's Common Stock was \$31.37 on February 23, 2010.

Beginning on March 5, 2010, UniSource Energy will have the option to redeem the 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 notes will have the right to require UniSource Energy to repurchase the 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 notes plus accrued and unpaid interest.

## Guarantees and Indemnities

In the normal course of business, UniSource Energy and certain subsidiaries enter into various agreements providing financial or performance assurance to third parties on behalf of certain subsidiaries. We enter into these agreements primarily to support or enhance the creditworthiness of a subsidiary on a stand-alone basis. The most significant of these guarantees at December 31, 2009 were:

- UES' guarantee of senior unsecured notes issued by UNS Gas (\$100 million) and UNS Electric (\$100 million);
- UES' guarantee of the \$60 million UNS Gas/UNS Electric Revolver;
- UniSource Energy's guarantee of approximately \$2 million in building lease payments for UNS Gas; and
- UniSource Energy's guarantee of the \$26 million of outstanding loans under the UED Credit Agreement. In February 2010, UED increased its borrowings under this agreement to \$35 million. As a result, UniSource Energy increased its guarantee to \$35 million.

To the extent liabilities exist under these contracts, such liabilities are included in the consolidated balance sheets.

In January 2010, TEP entered into an agreement to purchase 100% of the equity interest in Sundt Unit 4. We have indemnified the seller of Sundt Unit 4 from any sales, use, transfer or similar taxes or fees due relating to the purchase. The terms of the indemnification do not include a limit on potential future payments; however, we believe that the parties to the agreement have abided by all tax laws, and we do not have any additional tax obligations. We have not made any payments under the terms of this indemnification to date.

## Contractual Obligations

The following chart displays UniSource Energy's consolidated contractual obligations by maturity and by type of obligation as of December 31, 2009.

### UniSource Energy's Contractual Obligations - Millions of Dollars -

Payment Due in Years Ending December 31,	2010	2011	2012	2013	2014	2015 and after	Other	Total
<b>Long Term Debt</b>								
Principal <sup>(1)</sup>	\$ 32	\$ 578	\$ —	\$ —	\$ —	\$ 745	\$ —	\$1,355
Interest <sup>(2)</sup>	59	58	51	51	51	659	—	929
Capital Lease Obligations <sup>(3)</sup>	93	107	118	123	195	103	—	739
Operating Leases	2	1	1	—	—	1	—	5
<b>Purchase Obligations:</b>								
Fuel <sup>(4)</sup>	108	65	47	42	40	165	—	467
Purchased Power	111	35	18	49	2	2	—	217
Transmission	4	4	3	2	2	2	—	17
<b>Other Long-Term Liabilities <sup>(5)</sup>:</b>								
Pension & Other Post Retirement Obligations <sup>(6)</sup>	28	5	5	6	6	30	—	80
Acquisition of Springerville Coal Handling and Common Facilities	—	—	—	—	—	226	—	226
Building Commitments	2	1	—	—	—	—	—	3
Unrecognized Tax Benefits	—	—	—	—	—	—	19	19
<b>Total Contractual Cash Obligations</b>	<b>\$ 439</b>	<b>\$ 854</b>	<b>\$ 243</b>	<b>\$ 273</b>	<b>\$ 296</b>	<b>\$1,933</b>	<b>\$ 19</b>	<b>\$4,057</b>

- (1) TEP's variable rate IDBs are secured by letters of credit issued pursuant to TEP's Credit Agreement and 2008 Letter of Credit Facility which expire in 2011. Although the variable rate IDBs mature between 2018 and 2029, the above maturity reflects a redemption or repurchase of such bonds in 2011 as though the letters of credit terminate without replacement upon expiration of the TEP Credit Agreement and 2008 Letter of Credit Facility. In January 2010, TEP's 2008 Letter of Credit Facility was terminated on conversion of the 2008 Pima B Bonds to a fixed rate. Effective with the termination of the 2008 Letter of Credit Facility, \$130 million of variable rate IDBs mature in 2029. In February 2010, UED amended its \$26 million term loan facility (included in 2010 maturity above) to extend the termination date by two years to March 2012 and had net additional borrowings of \$9 million bringing the outstanding balance to \$35 million.
- (2) Excludes interest on revolving credit facilities.
- (3) Effective with commercial operation of Springerville Unit 3 in July 2006 and Unit 4 in December 2009, Tri-State and SRP are reimbursing TEP for various operating costs related to the common facilities on an ongoing basis, including 14% each of the Springerville Common Lease payments and 17% each of the Springerville Coal Handling Facilities Lease payments. TEP remains the obligor under these capital leases, and Capital Lease Obligations do not reflect any reduction associated with this reimbursement. In January 2010, TEP entered into an agreement to purchase 100% of the equity interest in Sundt Unit 4 from the owner participant for approximately \$52 million. The purchase price is subject to increase by 0.75% of the purchase price per month in the event that the purchase occurs after March 31, 2010.
- (4) Excludes TEP's liability for final environmental reclamation at the coal mines which supply the San Juan and Four Corners generating stations as the timing of payment has not been determined. See Note 4.
- (5) Excludes asset retirement obligations expected to occur through 2066.
- (6) These obligations represent TEP and UES' expected contributions to pension plans in 2010 and TEP's expected postretirement benefit costs to cover medical and life insurance claims as determined by the plans' actuaries. TEP and UES do not know and have not included pension contributions beyond 2010 due to the significant impact that returns on plan assets and changes in discount rates might have on such amounts. TEP previously funded the postretirement benefit plan on a pay-as-you-go basis. In 2009, TEP established a VEBA Trust to partially fund expected future benefits for union employees. Benefit payments are not expected to be made from the Trust for several years. The 2010 obligation includes expected VEBA contributions. VEBA contributions for periods beyond 2010 cannot be determined at this time.

We have reviewed our contractual obligations and provide the following additional information:

- We do not have any provisions in any of our debt or lease agreements that would cause an event of default or cause amounts to become due and payable in the event of a credit rating downgrade.
- None of our contracts or financing arrangements contains acceleration clauses or other consequences triggered by changes in our stock price.

## **Dividends on Common Stock**

On February 12, 2010, UniSource Energy declared a first quarter cash dividend of \$0.39 per share on its Common Stock. The first quarter dividend, totaling approximately \$14 million, will be paid March 8, 2010 to shareholders of record at the close of business February 23, 2010. During 2009, UniSource Energy paid quarterly dividends to its shareholders of 0.29 per share; for all of 2009, total dividends paid were \$41 million. In 2008, UniSource Energy paid quarterly dividends to its shareholders of \$0.24 per share; for all of 2008, total dividends paid were \$34 million.

## **Income Tax Position**

At December 31, 2009, UniSource Energy and TEP had federal AMT credit carryforwards of \$43 million and \$28 million, respectively, which do not expire. During 2009, UniSource Energy and TEP used all of their capital loss and state net operating loss carryforwards.

## **TUCSON ELECTRIC POWER COMPANY**

### **RESULTS OF OPERATIONS**

#### **Executive Summary**

TEP recorded net income of \$89 million in 2009 compared with \$4 million in 2008. The improvement in net income during 2009 is due primarily to: TEP's new retail rate structure; hot summer weather; lower fuel and purchased power costs; no provision for rate refunds recorded in 2009; and the elimination of TRA amortization expense that was incurred in 2008. In addition, 2008 results include a reduction in pre-tax expenses related to the reinstatement of regulatory accounting to TEP's generating assets resulting from the 2008 TEP Rate Order.

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Beginning on January 1, 2009, TEP implemented a PPFAC. The PPFAC allows recovery of actual fuel and purchased power costs from TEP's retail customers. The fuel and purchased power costs are off-set by the following, which are credited to the PPFAC: 100% of short-term wholesale revenues, 10% of the profit on trading activity and 50% of the revenues from the sale of SO<sub>2</sub> emission allowances. As a result of the PPFAC, relative to prior periods, TEP's net income is not as sensitive to changes in fuel and purchased power costs or revenues from short-term wholesale sales.

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

### 2009 Compared with 2008

The following factors contributed to the change in TEP's net income:

- a \$62 million increase in retail revenues due primarily to: the 6% base rate increase that took effect in December 2008; a new rate structure that charges higher rates for higher levels of energy usage; a \$23 million increase in revenues collected from customers for renewable energy and energy efficiency programs; and hot summer weather during the third quarter of 2009;
- a provision for rate refunds of \$58 million recorded in 2008;
- a \$9 million decrease in long-term wholesale revenues due primarily to lower kWh sales to Salt River Project (SRP) and Navajo Tribal Utility Authority (NTUA);
- a \$30 million decrease in total fuel and purchased energy expense, net of short-term wholesale revenues, due to lower generating output; a decline in the market price of wholesale power and natural gas; and a \$24 million gain recorded to fuel expense in 2008 related to the reinstatement of regulatory accounting;
- a \$33 million increase in O&M. Excluding a \$15 million increase in expenses directly offset by customer surcharges for renewable energy and energy efficiency programs and a \$6 million increase third party reimbursements, the increase in O&M was \$12 million, which resulted primarily from higher pension-related expenses and plant maintenance expenses.
- a \$27 million increase in depreciation and amortization expense due to: additions to plant in service; new depreciation rates for generation assets; and amortization of regulatory assets resulting from the 2008 TEP Rate Order;
- a \$24 million decrease in the amortization of TEP's TRA. In May 2008, the TRA was fully amortized;
- a \$6 million increase in taxes other than income taxes due primarily to a \$7 million gain recorded in 2008 resulting from the reinstatement of regulatory accounting;
- a \$10 million increase in total other income due to interest income related to an income tax refund, income related to an adjustment in the accounting for an investment in lease equity and income related to an increase in the value of a company owned life insurance policy; and
- an \$11 million decrease in total interest expense resulting primarily from lower interest rates on variable rate debt and lower interest expense related to capital lease obligations;

In 2009 and 2008, the pre-tax benefit recognized by TEP related to Springerville Units 3 and 4 for operating fees and contributions toward common facility costs was \$12 million in each period.

In June 2009, TEP adjusted its accounting for a 2006 investment in 14.14% of Springerville Unit 1 lease equity. As a result, TEP recorded a net increase to the income statement of \$0.6 million, before tax. The adjustment recorded in June 2009 for the period from July 2006 through June 2009 included additional depreciation expense of \$4 million; a reduction of interest expense on capital leases of \$2 million; and \$3 million of equity in earnings which is included in Other Income on the income statement.

**2008 Compared with 2007**

The following factors contributed to the decrease in TEP's net income:

- A \$9 million increase in total operating revenues due to:
  - a \$64 million increase in wholesale revenues due to increased short-term wholesale activity and related purchased power volumes, lower retail demand resulting in an increase in the availability of energy to sell into the wholesale market and an increase in the market price of wholesale power. Wholesale sales volumes increased 13% and the average price per MWh of wholesale power sold increased by 16%; and
  - a \$12 million increase in other revenues due primarily to fees and reimbursements received for fuel and O&M costs related to Springerville Units 3 and 4; partially offset by:
  - a \$58 million provision for revenues to be credited equivalent to the Fixed CTC revenue that was collected from customers after the TRA was fully amortized in early May 2008; and
  - a \$9 million decrease in retail revenues due to mild summer weather and a weakening local economy.
- A \$92 million increase in fuel and purchased power due to:
  - a \$98 million increase in purchased power expense. Purchased power volumes increased by 44% as a result of higher wholesale sales activity and replacement power purchases during the first and third quarters. The average price paid per MWh increased by 18% due to higher market prices for wholesale energy; and
  - a \$6 million decrease in fuel expense. Higher mining costs at San Juan, increased coal costs at Sundt Unit 4 and a 17% increase in the average cost per kWh of gas-fired generation due to higher natural gas prices, were offset by a \$25 million gain recorded to fuel expense related to the reinstatement of regulatory accounting.

Other factors impacting the comparability of results for 2008 include:

- a \$55 million increase in O&M expense due to: an \$11 million increase in O&M related to Springerville Units 3 and 4, which is reimbursed to TEP by the owners of those units and recorded in other revenues; an increase in generation plant maintenance of \$18 million; a \$13 million decrease in pre-tax gains from the sale of excess SO<sub>2</sub> Emission Allowances which is recorded as an offset to O&M; increased transmission expense; and general cost pressures resulting from inflation and other economic factors;
- a \$6 million increase in depreciation and amortization expense due to additions to plant in service;
- a \$54 million decrease in the amortization of TEP's TRA. In May 2008, the TRA was fully amortized;
- a \$9 million decrease in taxes other than income taxes due primarily to a \$7 million gain resulting from the reinstatement of regulatory accounting;
- a \$7 million decrease in other income due in part to lower interest income on investment in lease debt. The interest income declines over time as the lease debt is amortized; and
- a \$15 million decrease in total interest expense resulting primarily from lower balances on capital lease obligations.

In 2008 and 2007, the pre-tax benefit recognized by TEP related to Springerville Units 3 and 4 for operating fees and contributions toward common facility costs was \$12 million in each period.

**Utility Sales and Revenues**

Customer growth, weather and other consumption factors affect retail sales of electricity. Electric wholesale revenues are affected by market prices in the wholesale energy market, the availability of TEP generating resources, and the level of wholesale forward contract activity.

The table below provides trend information on retail sales by major customer class and electric wholesale sales made by TEP in the last three years as well as weather data for TEP's service territory.

<b>Energy Sales, kWh (in millions)</b>	<b>2009</b>	<b>2008</b>	<b>09-08 % Change*</b>	<b>2007</b>
<b>Electric Retail Sales:</b>				
Residential	3,906	3,852	1.4%	4,005
Commercial	1,988	2,034	(2.3%)	2,058
Industrial	2,161	2,264	(4.5%)	2,341
Mining	1,065	1,096	(2.8%)	983
Public Authorities	251	256	(1.9%)	247
<b>Total Electric Retail Sales</b>	<b>9,371</b>	<b>9,502</b>	<b>(1.4%)</b>	<b>9,634</b>
<b>Electric Wholesale Sales Delivered:</b>				
Long-term Contracts	833	1,096	(24.0%)	1,101
Short-term and Trading	2,222	2,873	(22.8%)	2,458
<b>Total Electric Wholesale Sales</b>	<b>3,055</b>	<b>3,969</b>	<b>(23.0%)</b>	<b>3,559</b>
<b>Total Electric Sales</b>	<b>12,426</b>	<b>13,471</b>	<b>(7.8%)</b>	<b>13,193</b>

<b>Electric Retail Revenues (in millions):</b>				
Residential	\$ 378	\$ 351	7.6%	\$ 363
Commercial	220	212	3.8%	214
Industrial	164	165	(0.7%)	168
Mining	61	55	9.7%	49
Public Authorities	20	19	3.8%	18
<b>Revenues excluding REST &amp; DSM</b>	<b>\$ 843</b>	<b>802</b>	<b>5.0%</b>	<b>812</b>
<b>REST and DSM Revenues</b>	<b>25</b>	<b>3</b>	<b>NM</b>	<b>5</b>
<b>Provision for Rate Refunds</b>	<b>—</b>	<b>(58)</b>	<b>NM</b>	<b>—</b>
<b>Total Retail Revenues</b>	<b>\$ 868</b>	<b>\$ 747</b>	<b>16.2%</b>	<b>\$ 817</b>

<b>Electric Wholesale Revenues:</b>				
Long-term Contracts	48	58	(17.2%)	56
Provision for Wholesale Refunds	(4)	—	NM	—
Other Sales	81	185	(55.1%)	125
Transmission	19	17	10.5%	15
<b>Total Wholesale Revenues</b>	<b>146</b>	<b>260</b>	<b>(43.9%)</b>	<b>196</b>
<b>Total Retail and Wholesale Revenues</b>	<b>\$ 1,012</b>	<b>\$ 1,007</b>	<b>0.6%</b>	<b>\$ 1,013</b>

<b>Weather Data:</b>				
	<b>2009</b>	<b>2008</b>	<b>09-08 % Change</b>	<b>2007</b>
<b>Cooling Degree Days</b>				
Actual	1,599	1,336	19.7%	1,517
10-Year Average	1,419	1,431	NM	1,424
<b>Heating Degree Days</b>				
Actual	1,287	1,367	(5.9%)	1,506
10-Year Average	1,481	1,444	NM	1,497

\* Percent change calculated on un-rounded data; may not correspond to data shown in table

**2009 Compared with 2008**Residential and Commercial

Residential kWh sales increased by 1.4% in 2009 due primarily to hotter than normal weather during the third quarter. Residential revenues increased \$27 million or 7.6% during 2009, benefitting from hot summer weather, as well as a base rate increase that became effective in December 2008.

Commercial kWh sales during 2009 were 2.3% below 2008. The decrease in commercial kWh sales was driven primarily by weak economic conditions. Revenues from commercial kWh sales increased by \$8 million, or 3.8%, as a result of the base rate increase that became effective in December 2008.

Industrial, Mining and Public Authorities

Sales volumes to industrial, mining and public authority customers decreased by a combined 3.8% in 2009 due primarily to the weak economy. Associated revenues were \$5 million higher than the same period last year as a result of the base rate increase that became effective in December 2008.

Retail Margin Revenues

The table below provides a summary of the margin revenues (retail revenues excluding base fuel, PPFAC and REST and DSM charges) on TEP's retail sales for 2009. Comparable data is not available for 2008 since TEP's new rate structure went into effect in December 2008.

**2009 Year-End**

	-millions-	-cents / kWh-
<b>Retail Margin Revenues (non-GAAP)*</b>		
Residential	\$ 253	6.48
Commercial	160	8.04
Industrial	99	4.59
Mining	31	2.93
Public Authorities	13	5.00
<b>Retail Margin Revenues (Non-GAAP)*</b>	<b>\$ 556</b>	<b>5.94</b>
Base Fuel & PPFAC Revenues	287	3.05
REST & DSM Revenues	25	0.27
<b>Net Electric Retail Sales (GAAP)</b>	<b>\$ 868</b>	<b>9.26</b>

\* 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. TEP believes that Retail Margin Revenues, which is Net Electric Retail Sales less base fuel and PPFAC revenues, and revenues for DSM and REST programs, provides useful information to investors as a measure of TEP's ability to pay for operating expenses with retail revenues, after giving effect to related fuel and purchased power expenses.

Long-Term Wholesale Revenues

Revenues from long-term wholesale contracts decreased by \$10 million in 2009 compared with last year primarily due to lower sales volumes to NTUA. In 2009, NTUA received a greater allotment of federal hydro power as hydro conditions in the Colorado River basin have been above normal. In addition, low gas prices made it more economic for one of their major customers to self-generate than to purchase power from NTUA. These factors led NTUA to purchase 17% less energy under its agreement with TEP compared with 2008. The gross margin (long-term wholesale revenues less the cost of energy, which is based on TEP's average fuel and purchased power costs) on TEP's long-term wholesale sales for 2009 was \$24 million. Prior to the implementation of the PPFAC in January 2009, TEP did not allocate fuel and purchased power costs to long-term wholesale sales.

**2008 Compared with 2007**Residential and Commercial

Residential kWh sales were 4% lower in 2008, resulting in a \$12 million or 3% decline in residential revenues. Mild weather accounted for \$7 million of the decrease, while other factors such as slower customer growth, economic conditions and customer usage patterns accounted for the remaining decrease.

Commercial kWh sales were 1% lower in 2008, resulting in a \$2 million or 1% decline in commercial revenues. Mild weather accounted for most of the decrease, while weak economic conditions and slower customer growth also contributed to the decline.

Industrial, Mining and Public Authorities

Industrial kWh sales were 3% lower in 2008, resulting in a \$3 million or 2% decline in industrial revenues. The decrease is due primarily to regional and national economic conditions. kWh sales and revenues to mining customers increased 11% and 12%, respectively, in 2008 compared with 2007. The increase is due to higher mining production as well as an increase in the rate charged to one of TEP's mining customers.

CTC Revenue to be Refunded

TEP deferred \$58 million of retail revenues in 2008 that is being credited to customers according to the 2008 TEP Rate Order. See *Factors Affecting Results of Operations, 2008 TEP Rate Order*, below for more information.

Long-Term Wholesale Revenues

Revenues from long-term wholesale contracts increased by \$2 million in 2008 compared with 2007. The average price per MWh sold under long-term contracts averaged \$53 per MWh in 2008 compared with \$51 per MWh in 2007. See *Factors Affecting Results of Operations, Long-Term Wholesale Contracts*, below for more information.

Short-Term Wholesale and Trading Revenues

Short-term wholesale sales volumes increased 23%, and revenues from short-term wholesale and trading activity increased by \$60 million or 48% compared with 2007. In 2008, 405,000 MWh of wholesale sales and purchases were due to a single transaction involving a purchase and resale between TEP and two wholesale counterparties. The wholesale revenues and purchased power expenses associated with this transaction were \$34 million and \$31 million, respectively. Lower retail demand also contributed to higher sales volumes and a 34% increase in the average market price of wholesale power contributed to higher revenue compared with 2007. All revenues from short-term wholesale sales and 10% of the profit on trading activity is credited to costs included in TEP's PPFAC.

**Other Revenues**

	<u>2009</u>	<u>2008</u>	<u>2007</u>
	-Millions of Dollars-		
Reimbursements related to Springerville Units 3 and 4 <sup>(1)</sup>	\$ 59	\$ 53	\$ 42
Other	24	19	16
<b>Total Other Revenue</b>	<u>\$ 83</u>	<u>\$ 72</u>	<u>\$ 58</u>

<sup>(1)</sup> Represents reimbursements from Tri-State and SRP, the owners of Springerville Units 3 and 4, respectively, for expenses incurred by 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; miscellaneous service-related revenues such as power pole attachments; damage claims; and customer late fees.

**Operating Expenses****2009 Compared with 2008**Generation and Purchased Power Summary

TEP's fuel and purchased power expense, and energy resources for 2009, 2008 and 2007 are detailed below:

	<b>Generation/Purchases</b>			<b>Expense</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
	-Millions of kWh-			-Millions of Dollars-		
Coal-Fired Generation	9,272	10,573	10,970	\$ 202	\$ 235	\$ 213
Gas-Fired Generation	986	871	1,088	75	74	79
Renewable Generation	30	34	32	1	—	—
Total	10,288	11,478	12,090	278	309	292
Regulatory Accounting Reinstatement <sup>(1)</sup>	—	—	—	—	(24)	—
Total Generation <sup>(2)</sup>	10,288	11,478	12,090	278	285	292
Purchased Power	3,086	2,948	2,047	142	238	140
Transmission	—	—	—	3	11	9
Increase (Decrease) to Reflect PPFAC Recovery Treatment	—	—	—	(20)	—	—
Total Resources	13,374	14,426	14,137	\$ 402	\$ 534	\$ 441
Less Line Losses and Company Use	948	955	944			
Total Energy Sold	12,426	13,471	13,193			

(1) See Note 2 . *Regulatory Matters*, for more information.

(2) Fuel expense excludes \$5 million in 2009, 2008 and 2007, related to Springerville Unit 3; the fuel costs incurred on behalf of Unit 3 are recorded in Fuel Expense and the reimbursement by Tri-State is recorded in Other Revenue.

PPFAC

TEP's PPFAC became effective in January 2009 and allows TEP to pass through its actual fuel, purchased power and transmission costs net of short-term wholesale revenues and other offsets to its retail customers. For comparative purposes, those PPFAC related costs decreased by \$30.5 million in 2009 compared with 2008. The decrease was due primarily to lower wholesale market prices for energy and natural gas. See *2008 TEP Rate Order , Purchased Power and Fuel Adjustment Clause* , below for more information.

Energy Resources

In 2009, coal-fired generation decreased by 12% due to: fuel switching at Sundt Unit 4 from coal to natural gas; a 1% decrease in retail kWh sales; and lower coal plant availability. Coal-related fuel expense, excluding a \$24 million gain recorded in 2008 related to the adoption of regulatory accounting, decreased by \$33 million during 2009. The lower generating output, as well as \$9 million of expenses recorded in the third quarter of 2008 related to a settlement of mining-related costs, led to the decrease in coal-related fuel expense in 2009.

Fuel switching at Sundt Unit 4 led to a 13% increase in gas-fired generating output in 2009 compared with 2008; however, gas-related fuel expense increased by just \$1 million due to a decrease in the average price for natural gas. Under TEP's new rate structure, hedging activities are reflected in the PPFAC.

Purchased power volumes increased by 5% in 2009 compared with 2008, as it was more economic for TEP to purchase power in the wholesale energy market rather than run certain of its less efficient gas-fired units. The average price paid by TEP for purchased power during 2009 was approximately \$46 per MWh, compared with an average cost of \$76 per MWh for generating output from TEP's gas-fired generating resources.

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

	<u>2009</u>	<u>2008</u>	<u>2007</u>
		-cents per kWh generated-	
Coal	2.18	2.22	1.93
Gas	7.60	8.49	7.26
Purchased Power	4.57	8.07	6.84

#### 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 annual market price for around-the-clock energy based on the Dow Jones Palo Verde Index and the average annual price for natural gas based on the Permian Index were higher in 2009 compared with 2008. We cannot predict whether changes in various factors that influence demand and supply will cause prices to change during 2010.

<b>Avg. Market Price for Around-the-Clock Energy — \$/MWh</b>	<u>2009</u>	<u>2008</u>	<u>2007</u>
Year ended December 31	\$ 30	\$ 63	\$ 47

<b>Avg. Market Price for Natural Gas — \$/MMBtu</b>	<u>2009</u>	<u>2008</u>	<u>2007</u>
Year ended December 31	\$ 3.34	\$ 7.41	\$ 6.11

#### TRA Amortization

TEP did not record any TRA amortization during 2009, as the TRA balance was amortized to zero in May 2008. TRA amortization was \$24 million in 2008. Amortization of the TRA was the result of the 1999 Settlement Agreement with the ACC, which changed the accounting method for TEP's generation operations. This item reflected the recovery, through 2008, of transition recovery assets which were previously regulatory assets related to the generation business.

#### O&M

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

	<u>2009</u>	<u>2008</u>	<u>2007</u>
	-Millions of Dollars-		
Base O&M	\$ 231	\$ 220	\$ 192
Reimbursed Expenses Related to Springerville Units 3 and 4	41	35	24
Gain on the Sale of SO <sub>2</sub> Emissions Allowances	—	(1)	(15)
Expenses related to customer-funded renewable energy programs <sup>(1)</sup>	18	3	2
Reinstatement of Regulatory Accounting	—	(1)	—
Total O&M	<u>\$ 290</u>	<u>\$ 257</u>	<u>\$ 203</u>

<sup>(1)</sup> Represents expenses related TEP's customer-funded renewable energy programs; the offsetting funds collected from customers are recorded in other revenue.

#### Income Tax Expense

In 2009, TEP's effective tax rate was 38% compared with 71% in 2008. In 2008, it was determined that the environmental penalties at San Juan would not be deductible for income tax purposes. As a result, an additional \$3 million of tax expense was recognized in 2008 for penalties incurred in the current and prior years. Other items included in GAAP expense which will not be deductible for tax were offset by the recognition of income tax credits. See *Note 9. Income Taxes*, for more information.

## Operating Expenses

### 2008 Compared with 2007

#### Coal

Coal-fired generating output decreased by 4% compared with 2007, due to lower coal plant availability resulting from planned and unplanned outages. Coal-related fuel expense, excluding the gain related to the reinstatement of regulatory accounting, increased by \$22 million due primarily to higher mining-related costs at San Juan and Navajo, and increased coal costs at Sundt Unit 4.

#### Gas

Gas-fired generating output decreased by 20% due primarily to slower customer growth and mild weather. Gas-related fuel expense was \$5 million, or 6%, lower than 2007 due in part to a decrease in realized losses on gas hedging activity. The average cost per kWh generated by TEP's gas-fired fleet for 2008 increased 17% compared with 2007.

#### Purchased Power

Power purchase volumes increased 42% in 2008 compared with 2007, leading to a \$98 million increase in purchased power expense. The higher purchased power volume and expense is due partially to higher short-term wholesale sales activity and replacement power purchases related to lower coal plant availability. In 2008, 405,000 MWh of wholesale sales and purchases were due to a single transaction involving a purchase and resale between TEP and two wholesale counterparties. The wholesale revenues and purchased power expenses associated with this transaction were \$34 million and \$31 million, respectively.

## FACTORS AFFECTING RESULTS OF OPERATIONS

### 2008 TEP Rate Order

#### Base Rate Increase

TEP received a base rate increase, effective December 1, 2008, of approximately 6% over its previous average retail rate of 8.4 cents per kWh. TEP's new base rates are expected to increase retail revenue by approximately \$50 million annually. The average base rate is 8.8 cents per kWh and includes approximately 2.9 cents per kWh for fuel and purchased power costs.

#### Purchased Power and Fuel Adjustment Clause

The PPFAC became effective starting January 1, 2009. The PPFAC allows recovery of fuel and purchased power costs, including demand charges, transmission costs and the prudent costs of contracts for hedging fuel and purchased power costs. The PPFAC consists of a forward component and a true-up component.

- The forward component was established as of April 1, 2009 and will be updated on April 1 of each year. The forward component is based on the forecasted fuel and purchased power costs for the 12-month period from April 1 to March 31, less the base cost of fuel and purchased power of 2.9 cents per kWh, which is embedded in base rates. The ACC approved a forward component of 0.18 cents per kWh, effective April 1, 2009.
- The true-up component will reconcile any over/under collected amounts from the preceding 12 month period and will be credited to or recovered from customers in the subsequent year.

As part of the reconciliation of fuel and purchased power costs and PPFAC revenues, TEP credits the following against the recoverable costs: 100% of short-term wholesale revenues; 10% of the profit on trading activity; and 50% of the revenues from the sales of SO<sub>2</sub> emission allowances.

On a cash basis, Fixed CTC revenue to be refunded (\$58 million collected from May 2008 to November 30, 2008) will be credited to customers as an offset to the PPFAC. This credit will off-set the forward and true-up components of the PPFAC, resulting in a PPFAC charge of zero until the Fixed CTC revenue to be refunded is fully credited, which is expected to occur over 36 to 48 months beginning April 1, 2009.



### Base Rate Increase Moratorium

TEP's base rates are frozen through December 31, 2012. TEP is prohibited from submitting a base rate application before June 30, 2012. The test year to be used in TEP's next base rate application must be no earlier than December 31, 2011.

Notwithstanding the rate increase moratorium, base rates and adjustor mechanisms may be changed in emergency conditions which are 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.

### **Springerville Units 3 and 4**

TEP operates Springerville Unit 3 on behalf of Tri-State and receives annual benefits in the form of rental payments and other fees and cost savings. TEP recorded pre-tax benefits of \$12 million in 2009 and 2008.

Springerville Unit 4 was completed in December 2009. TEP operates Springerville Unit 4 on behalf of SRP and expects to receive annual pre-tax benefits beginning in 2010 of approximately \$8 million in the form of rental payments and other fees and cost savings.

### **Depreciation**

In January 2010, TEP completed an updated depreciation study which indicated that its transmission assets' depreciable lives should be extended. As a result, TEP adopted new transmission depreciation rates effective January 2010 which will have the effect of reducing depreciation expense by approximately \$14 million in 2010.

### **Sundt Unit 4**

Sundt Unit 4 is leased by TEP and the term of the lease expires in January 2011. In January 2010, TEP entered into an agreement to purchase 100% of the equity interest in Sundt Unit 4 from the equity owner for approximately \$52 million. The purchase price is subject to increase by 0.75% of the purchase price per month in the event that the purchase occurs after March 31, 2010. TEP expects to finalize the purchase prior to March 31, 2010. Following the completion of the transaction, TEP expects to redeem the outstanding Sundt Unit 4 lease debt of \$5 million, terminate the lease agreement and cause title of Sundt Unit 4 to be transferred to TEP.

### **Refinancing Activity**

The TEP Credit Agreement, which consists of a \$150 million revolving credit facility and a \$341 million letter of credit facility, matures in August 2011. Interest rates and fees under the TEP Credit Agreement are based on a pricing grid tied to TEP's credit ratings. Letter of credit fees are 0.45% per annum and amounts drawn under a letter of credit would bear interest at LIBOR plus 0.45% per annum. Based on our current estimates, we believe that the interest costs associated with TEP's credit agreement after it is refinanced will increase over current levels. At December 31, 2009, there were \$35 million of borrowings at an interest rate of 0.68% and \$1 million in letters of credit outstanding under the Revolving Credit Facility. We are continuously monitoring conditions in the capital markets in order to achieve favorable terms and conditions. See *Liquidity and Capital Resources, TEP Credit Agreement*, below for more information .

### **Pension and Postretirement Benefit Expense**

In 2009 and 2008, TEP charged \$17 million and \$10 million, respectively, of pension and postretirement benefit expenses to O&M expense. In 2010, TEP expects to charge \$15 million of pension and postretirement benefit expense to O&M expense. The expected decrease in 2010 compared with 2009 is due primarily to the increase in the market value of the pension asset values. See *Note 10. Employee Benefit Plans* , for more information.

## El Paso Electric Dispute

TEP was a party to a proceeding at FERC that involved the interpretation of the 1982 Power Exchange and Transmission Agreement (1982 Agreement) between TEP and El Paso. The dispute related to TEP's ability to use existing rights for the transmission of power from Luna into TEP's system. On November 13, 2008, the FERC issued a decision that supported TEP's position. As a result of the ruling, El Paso refunded to TEP pre-tax amounts of \$10 million in disputed transmission charges and \$1 million of accrued interest. TEP is no longer accruing transmission charges under this agreement. In January 2009, FERC granted El Paso's request for a rehearing in this matter. As a result of the pending appeal process, TEP's net income in 2008 or 2009 does not reflect the refund made by El Paso. TEP does not expect to recognize any income related to this refund until the appeals process is fully resolved.

In December 2008, TEP filed a complaint in the U.S. Federal District Court against El Paso seeking a \$2 million reimbursement for transmission charges paid by TEP to PNM for transmission service in an attempt to mitigate TEP's damages before FERC issued its decision in November 2008. On February 23, 2009, El Paso filed a motion to dismiss TEP's complaint, or in the alternative, requested a stay in the proceeding pending further resolution by FERC. In April 2009, TEP filed a response requesting that the court deny El Paso's motion, followed by an El Paso reply in May 2009. On September 10, 2009, the District Court denied El Paso's motion to dismiss and stayed the proceeding pending a final resolution of the FERC proceeding and any appeal. TEP cannot predict the timing or outcome of this lawsuit.

## Emission Allowances

TEP has SO<sub>2</sub> Emission Allowances in excess of what is required to operate its generating units. The excess results primarily from a higher removal rate of SO<sub>2</sub> emissions at Springerville Units 1 and 2 following recent upgrades to environmental plant components and related changes to plant operations. From time to time, TEP will sell a portion of its excess SO<sub>2</sub> Emission Allowances. The table below summarizes sales made since 2007.

Delivery	Allowances Sold	Pre-tax Gain (millions)
2007	22,000	\$ 15
2008	4,000	1
2009	—	—

Existing regulations call for a reduction to the EPA SO<sub>2</sub> Emissions Allowances allocation beginning in 2010. As a result, starting in 2010 and for the remaining life of the program, TEP's annual SO<sub>2</sub> Emissions Allowance allocation will be approximately 28,000 allowances. The exact number of excess allowances for future years cannot be determined until the SO<sub>2</sub> allowance consumption for each year is verified by EPA. TEP expects to have approximately 13,000 excess SO<sub>2</sub> Emission Allowances annually beginning in 2010 and for the remaining life of the program. The decline in sales of SO<sub>2</sub> allowances from 2007 to 2009 is a result of a decrease in the market price for the allowances.

As part of the 2008 TEP Rate Order, TEP will credit 50% of the revenue from the sales of its SO<sub>2</sub> Emissions Allowances to the PPFAC. As of January 1, 2010, the average market price of SO<sub>2</sub> Emissions Allowances was \$59. On December 31, 2008 and 2007, the market price of SO<sub>2</sub> Emissions Allowances was \$205 and \$534, respectively.

## Competition

TEP's customers have the ability to install renewable energy technologies and conventional generation units that could reduce their reliance on TEP's services in the future. 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

TEP began implementing its ACC approved REST plan on June 1, 2008. In 2009 and 2008 TEP collected \$29 and \$9 million in REST surcharges, of which \$25 million and \$3 million, respectively, were expensed for REST projects, respectively. Any surcharge collections above or below the amount of renewable expenditures will be deferred and reflected in TEP's financial statements as a regulatory liability or asset. In 2010, TEP expects to collect \$32 million from customers through the REST. REST implementation plans and the associated surcharge must be submitted annually to the ACC for review and approval. For more information, see *Item 1. Business, TEP, Renewable, Energy Standard and Tariff*, above.



## Electric Energy Efficiency Standards

In December 2009, the ACC established a process to adopt new Electric Energy Efficiency Standards (EE Standards) designed to require TEP, UNS Electric and other affected utilities to implement DSM programs, only to the extent that they are cost effective. The proposed EE Standards target cost effective total kWh savings in 2011 of 1.25% and ramping up each year to reach a targeted cumulative annual reduction in retail kWh sales of 22% by 2020. Savings from Direct Load Control programs, previously implemented DSM programs and from a portion of energy efficient building codes may be counted towards meeting the target. The proposed EE Standards provide for recovery of costs incurred to implement cost effective DSM programs. TEP's DSM programs and rates charged to customers for such programs are subject to ACC approval. If the ACC approves EE Standards, they must be certified by the Arizona Attorney General before taking affect.

## Rosemont Copper Mine

In 2007, Augusta Resources Corporation (Augusta) filed a plan of operations with the United States Forest Service (USFS) for the proposed Rosemont Copper Mine near Tucson, Arizona. Augusta is waiting for an environmental impact statement from the USFS before it can begin construction and operation of the mine. If the Rosemont Copper Mine begins full production, it would become TEP's largest retail customer, with an estimated annual load of up to 110 MW. TEP cannot predict if or when the mine will commence operations.

## Fair Value Measurements

As described in Note 12 to the Notes to Consolidated Financial Statements, TEP adopted fair value accounting, on January 1, 2008 which, among other things, establishes a three-tier value hierarchy, based on the valuation techniques used to determine the fair value of derivative assets and liabilities.

The following table sets forth, by level within the fair value hierarchy, TEP's financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2009. As required by fair value accounting, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

	TEP			Total
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
<b>December 31, 2009</b> - Millions of Dollars -				
<b>Assets</b>				
Cash Equivalents <sup>(1)</sup>	\$ 8	\$ —	\$ —	\$ 8
Rabbi Trust Investments to support the Deferred Compensation and SERP Plans <sup>(2)</sup>	—	14	—	14
Energy Contracts <sup>(3)</sup>	—	1	5	6
<b>Total Assets</b>	<b>8</b>	<b>15</b>	<b>5</b>	<b>28</b>
<b>Liabilities</b>				
Energy Contracts <sup>(3)</sup>	—	(5)	(9)	(14)
Interest Rate Swaps <sup>(4)</sup>	—	(6)	—	(6)
<b>Total Liabilities</b>	<b>—</b>	<b>(11)</b>	<b>(9)</b>	<b>(20)</b>
<b>Net Total Assets and (Liabilities)</b>	<b>\$ 8</b>	<b>\$ 4</b>	<b>\$ (4)</b>	<b>\$ 8</b>

- (1) Cash Equivalents are based on observable market prices and are comprised of the fair value of money market funds and certificates of deposit.
- (2) Level 2 investments comprise amounts held in mutual and money market funds related to deferred compensation and Supplemental Executive Retirement Plan (SERP) benefits. The valuation is based on quoted prices, traded in active markets. These investments are included in Investments and Other Property — Other in the UniSource Energy and TEP balance sheets.
- (3) Energy contracts include gas swap agreements (Level 2), forward power purchase and sales contracts (Level 3), and forward power purchase contracts indexed to gas (Level 3), entered into to take advantage of favorable market conditions and reduce exposure to energy price risk. The valuation techniques are described below.
- (4) Interest Rate Swaps are valued based on the six month LIBOR index or the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index.

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TEP recorded in 2009, net unrealized losses of \$2 million in net Regulatory Assets and \$1 million as other comprehensive income due to the change in the fair value of commodity derivative contracts classified as Level 3 in the fair value hierarchy.

### Valuation Techniques

TEP values its energy derivative contracts by obtaining market quotes for periods and delivery points where an active market exists. For both power and gas prices, TEP obtains quotes from brokers, major market participants, exchanges or industry publications. TEP primarily uses one set of quotations each for power and for gas, and then use the other sources as validation of those prices. The broker providing quotes for power prices states that the market information provided is indicative only, but believes it to be reflective of market conditions as of the time and date indicated.

TEP's Level 3 derivatives include certain energy contracts where published prices are not readily available. These include contracts for delivery periods during non-standard time blocks, contracts for delivery during only a few months of a given year when prices are quoted only for the annual average, or contracts for delivery at illiquid delivery points. In these cases, TEP applies certain management assumptions to value such contracts. These assumptions include applying percentage multipliers to value non-standard time blocks, applying historical price curve relationships to calendar year quotes, and including adjustments for transmission and line losses to value contracts at illiquid delivery points. 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. The fair value of TEP's purchase power call option is estimated using an internal pricing model which includes assumptions about market risks such as liquidity, volatility, and contract valuation. TEP's model also considers credit and non-performance risk. TEP reviews these assumptions on a quarterly basis.

### LIQUIDITY AND CAPITAL RESOURCES

#### TEP Cash Flows

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

	<u>2009</u>	<u>2008</u>	<u>2007</u>
	-Millions of Dollars-		
Net Cash Flows — Operating Activities (GAAP)	\$ 268	\$ 269	\$ 264
Amounts from Statements of Cash Flows:			
Less: Capital Expenditures	(235)	(295)	(163)
Net Cash Flows after Capital Expenditures (non-GAAP)*	<u>33</u>	<u>(26)</u>	<u>101</u>
Amounts from Statements of Cash Flows:			
Less: Retirement of Capital Lease Obligations	(24)	(74)	(71)
Plus: Proceeds from Investment in Lease Debt	<u>13</u>	<u>25</u>	<u>28</u>
Net Cash Flows after Capital Expenditures and Required Payments on Debt and Capital Lease Obligations (non-GAAP)*	<u>\$ 22</u>	<u>\$ (75)</u>	<u>\$ 58</u>
	<u>2009</u>	<u>2008</u>	<u>2007</u>
Net Cash Flows — Operating Activities (GAAP)	\$ 268	\$ 269	\$ 264
Net Cash Flows — Investing Activities (GAAP)	(250)	(391)	(137)
Net Cash Flows — Financing Activities (GAAP)	(29)	129	(120)
Net Cash Flows after Capital Expenditures (non-GAAP)*	33	(26)	101
Net Cash Flows after Capital Expenditures and Required Payments on Debt and Capital Lease Obligations (non-GAAP)*	22	(75)	58

\* Net Cash Flows after Capital Expenditures and Net Cash Flows Available after Required Payments, 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 as a measure of liquidity. We believe that Net Cash Flows after Capital Expenditures and Net Cash Flows Available after Required Payments provide useful information to investors as measures of liquidity and our ability to fund our capital requirements, make required payments on debt and capital lease obligations, and pay dividends to UniSource Energy.



## Liquidity Outlook

During 2010, 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 2009, net cash flows from operating activities decreased by \$1 million compared with 2008. Net cash flows were impacted by:

- a \$65 million increase in cash receipts from retail and wholesale electric sales, less fuel and purchased power costs, due to: an increase in retail electric cash receipts resulting from the rate increase that became effective in December 2008 and cash collections from retail customers that are used to offset expenses related to renewable energy and energy efficiency programs; and lower market prices for natural gas and purchased power;
- an \$11 million decrease in total interest paid resulting from lower rates on variable rate debt and lower capital lease interest paid; offset by
- a \$39 million increase in O&M costs related to: costs associated with renewable energy and energy efficiency programs that are offset by funds collected from retail customers; an increase in pension-related costs; extensive planned generating plant outage and maintenance costs; general cost pressures resulting from inflation; and O&M related to Springerville Units 3 and 4 that is reimbursed by the plant owners;
- a \$27 million increase in total taxes paid (net of refunds received) due primarily to higher taxable income; and
- a \$12 million increase in wages paid.

## Investing Activities

Net cash used for investing activities was \$141 million lower in 2009 compared with 2008 primarily due to: a \$133 million deposit made last year by TEP to the trustee for bonds that matured in August 2008; and a \$59 million decrease in capital expenditures; partially offset by a \$31 million investment in Springerville Unit 1 lease debt; and a \$12 million decrease in proceeds from investments in lease debt and equity. See *Financing Activities*, *Investments in Springerville Lease Debt and Equity*, below for more information.

### Capital Expenditures

TEP's forecasted capital expenditures are summarized below:

<u>Category</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
	-Millions of Dollars-				
Transmission and Distribution	\$ 107	\$ 117	\$ 91	\$ 99	\$ 73
Generation Facilities	108	65	65	72	64
Environmental	8	5	11	24	44
General and Other	35	30	36	30	28
Total	<u>\$ 258</u>	<u>\$ 217</u>	<u>\$ 203</u>	<u>\$ 225</u>	<u>\$ 209</u>

- Included in TEP's capital expenditures forecast for 2010 is \$52 million for the proposed purchased of Sundt Unit 4. See *Sundt Unit 4*, above, for more information.
- Items excluded from TEP's capital expenditures forecast are: the estimated cost to construct proposed Tucson to Nogales, Arizona transmission line of \$120 million; estimated costs of \$300 million between 2011-2014 to construct 75 to 150 MW of local generation that may be required in 2015.

See Item 1 . *Business, Tucson Electric Utility Operations, Transmission Access, Tucson to Nogales Transmission Line* for more information.

All of these estimates are subject to continuing review and adjustment. Actual capital expenditures may be different from these estimates due to changes in business conditions, construction schedules, environmental requirements, and changes to TEP's business arising from retail competition. TEP plans to fund its capital expenditures through internally generated cash flow.

#### Investments in Springerville Lease Debt

At December 31, 2009, TEP had \$95 million of investments in lease debt on its balance sheet. In March 2009, TEP made a \$31 million purchase of Springerville Unit 1 lease debt. The table below provides a summary of the investment balances in lease debt.

<u>Leased Asset</u>	<u>Lease Debt Investment Balance</u>	
	<u>December 31, 2009</u>	<u>December 31, 2008</u>
	- In Millions -	
Investments in Lease Debt:		
Springerville Unit 1	\$ 88	\$ 59
Springerville Coal Handling Facilities	7	20
Total Investment in Lease Debt	<u>\$ 95</u>	<u>\$ 79</u>

Unless TEP makes new investments in lease debt, the investment in lease debt balance declines over time due to the amortization of lease debt that occurs as a result of the normal payments TEP makes on its capital lease obligations. The Springerville Unit 1 and Springerville Coal Handling Facilities leases expire in 2015.

See *Note 6 of Notes to Consolidated Financial Statements — Debt, Credit Facilities and Capital Lease Obligations*

#### **Financing Activities**

Net cash proceeds from financing activities were \$158 million lower in 2009 compared with 2008 due to: proceeds of \$221 million received in 2008 related to long-term debt issuances; and a \$58 million increase in dividends paid to UniSource Energy in 2009; partially offset by a \$25 million increase in net proceeds from revolving credit facility borrowings; a \$30 million capital contribution from UniSource Energy; a decrease in payments for capital lease obligations of \$50 million; and a \$10 million decrease in repayments of long-term debt.

#### TEP Credit Agreement

The TEP Credit Agreement consists of a \$150 million revolving credit facility and a \$341 million letter of credit facility which supports \$329 million of tax-exempt variable rate bonds. The TEP Credit Agreement matures in 2011 and is secured by \$491 million of Mortgage Bonds. At December 31, 2009, there were \$35 million of borrowings at an interest rate of 0.68% and \$1 million in letters of credit outstanding under the Revolving Credit Facility.

Interest rates and fees under the TEP Credit Agreement are based on a pricing grid tied to TEP's credit ratings. Letter of credit fees are 0.45% per annum and amounts drawn under a letter of credit would bear interest at LIBOR plus 0.45% per annum. TEP has the option of paying interest on borrowings under the revolving credit facility at LIBOR plus 0.45% or the greater of the federal funds rate plus 0.5% or the agent bank's reference rate.

The TEP Credit Agreement restricts additional indebtedness, liens, sale of assets and sale-leaseback agreements. The TEP Credit Agreement also requires TEP to meet a minimum cash coverage ratio and a maximum leverage ratio. If TEP complies with the terms of the TEP Credit Agreement, it may pay dividends to UniSource Energy.

In September 2008, as a result of higher than expected fuel and purchased power costs, TEP amended its credit agreements to provide more flexibility to meet the required leverage ratio. The leverage ratio is calculated as a ratio of total indebtedness to earnings before interest, taxes, depreciation and amortization. Although fuel and purchase power expenses have decreased in recent months, current economic conditions could result in lower customer growth rates and lower sales. If TEP's financial results are impacted by the economic downturn, our ability to comply with financial covenants could be jeopardized and we may seek waivers or amendments of the covenants.

As of December 31, 2009, TEP was in compliance with the terms of the TEP Credit Agreement.

If an event of default occurs, the TEP Credit Agreement may become immediately due and payable. An event of default includes failure to make required payments under the TEP Credit Agreement; change in control, as defined; failure of TEP or certain subsidiaries to make payments or default on debt greater than \$20 million; or certain bankruptcy events at TEP or certain subsidiaries.

#### TEP Letter of Credit Facility

In 2008, TEP entered into a three-year \$132 million letter of credit and reimbursement agreement (2008 TEP Letter of Credit Facility). The 2008 TEP Letter of Credit Facility supported \$130 million aggregate principal amount of variable rate tax-exempt IDBs that were issued on behalf of TEP in June 2008.

The 2008 TEP Letter of Credit Facility was terminated in January 2010 upon the conversion of the interest rate mode on the tax-exempt IDBs from variable to fixed rate, and the mortgage bonds securing the facility were cancelled. See *Bond Issuances*, below.

#### Capital Contribution from UniSource Energy

In March 2009, UniSource Energy contributed \$30 million of capital to TEP. TEP used the proceeds to purchase Springerville Unit 1 lease debt. There were no capital contributions from UniSource Energy to TEP in 2008.

#### Bond Issuances

In October 2009, the Pima Authority issued approximately \$80 million of its 2009 Series A tax-exempt pollution control bonds (2009 Pima A San Juan Bonds) for TEP's benefit. At the same time, the Coconino County, Arizona Pollution Control Corporation issued approximately \$15 million of its 2009 Series A tax-exempt pollution control bonds (2009 Coconino A Bonds) for TEP's benefit. The 2009 Pima A San Juan bonds are unsecured, bear interest at a rate of 4.95%, mature on October 1, 2020, and are not callable prior to maturity. The 2009 Coconino A Bonds are unsecured, bear interest at 5.125%, mature on October 1, 2032, and are callable at par beginning October 1, 2019. Semi-annual interest payments on both series of bonds are payable beginning April 1, 2010. TEP capitalized approximately \$1 million in costs related to the issuance of these bonds and will amortize the costs for each through the respective maturity dates.

The proceeds from the issuance of the 2009 Pima A San Juan Bonds and the 2009 Coconino A Bonds were deposited with a trustee and were used in November 2009 to redeem approximately \$80 million of 6.95% 1997 Series A City of Farmington, New Mexico Pollution Control Bonds and approximately \$15 million of 7.0% 1997 Series B Coconino County Pollution Control Bonds, respectively. The average annual interest savings is expected to be approximately \$2 million.

In March 2008, the Pima Authority issued approximately \$91 million of its 2008 Series A tax-exempt IDBs (2008 Pima A Bonds) for TEP's benefit. The proceeds were used to redeem a corresponding principal amount of bonds previously issued by the Pima Authority for TEP's benefit which TEP repurchased in 2005. TEP did not cancel the Repurchased Bonds, which remained outstanding under their respective indentures but were not reflected as debt on the balance sheet. As holder of the Repurchased Bonds being redeemed, TEP received the payment of the redemption price. TEP used \$75 million of the redemption price proceeds to repay loans outstanding under its revolving credit facility and \$10 million to redeem a portion of TEP's Collateral Trust Bonds that matured on August 1, 2008. The 2008 Pima A Bonds are unsecured, bear interest at the rate of 6.375%, mature on September 1, 2029 and are callable at par in March 2013.

In June 2008, the Pima Authority issued \$130 million of its 2008 Series B tax-exempt IDBs (2008 Pima B Bonds) for TEP's benefit. The proceeds were used to redeem a corresponding principal amount of bonds previously issued by the Pima Authority for TEP's benefit which TEP repurchased in 2005. TEP did not cancel the Repurchased Bonds, which remained outstanding under their respective indentures but were not reflected as debt on the balance sheet. As holder of the Repurchased Bonds being redeemed, TEP received the payment of the redemption price. TEP used \$128 million of the redemption price proceeds to redeem the remaining 7.5% Collateral Trust Bonds that matured on August 1, 2008. The 2008 Pima B Bonds were supported by a letter of credit (LOC) issued under the 2008 TEP Letter of Credit Facility. See *TEP Letter of Credit Facility*, above.

In January 2010, TEP converted the interest mode on the 2008 Pima B Bonds to a fixed rate. The 2008 Pima B bonds were reoffered in January 2010 with a term rate of 5.75% through maturity of September 2029. Interest is payable semi-annually beginning June 1, 2010. The bonds are callable at par beginning January 2015. Although the fixed interest rate is higher than the variable interest rate that was in effect at the time of the conversion, the fixed rate conversion reduced TEP's future interest rate risk and allowed TEP to terminate the LOC and cancel the mortgage bonds. See *Interest Rate Risk* and *Tax Exempt Local Furnishing Bonds*, below for additional information.

#### Interest Rate Risk

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 December 31, 2009 and December 31, 2008, TEP had \$459 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 was 10% on the \$130 million of 2008 Pima B Bonds and is 20% on the other \$329 million in IDBs. During 2008, the average rates paid ranged from 0.55% to 8.09%. During 2009, the average rates paid have ranged from 0.25% to 0.79%. At February 23, 2010, the average rate on the debt was 0.24%.

In August 2009, TEP reduced its exposure to variable interest rate risk by entering into an interest rate swap that had the effect of converting \$50 million of its variable rate IDBs to a fixed interest rate from September 2009 to September 2014. See Item 7A. *Quantitative and Qualitative Disclosures about Market Risk, Interest Rate Risk*, below.

In January 2010, TEP completed a transaction that converted the interest rate on the \$130 million of 2008 Pima B Bonds to a fixed rate of 5.75%. See *Bond Issuances*, above.

#### Interest Rate Swaps — Springerville Common Facilities Lease Debt

In 2006 and May 2009, TEP entered into interest rate swaps to hedge the floating interest rate risk associated with the Springerville Common Facilities Lease Debt. Interest on the lease debt is payable at six-month LIBOR plus a spread. The applicable spread was 1.625% as of December 31, 2009 and 1.5% as of December 31, 2008. The swaps have the effect of fixing the interest rates on \$65 million of the lease debt outstanding at December 31, 2009 at rates ranging from 3.18% to 5.77%.

#### Mortgage Indenture

TEP's Mortgage creates a lien on and security interest in most of TEP's utility plant assets. Springerville Unit 2, which is owned by San Carlos, is not subject to this lien and security interest. The Mortgage allows TEP to issue additional mortgage bonds on the basis of (1) a percentage of net utility property additions and/or (2) the principal amount of retired mortgage bonds. The amount of bonds that TEP may issue is also subject to a net earnings test under the Mortgage.

TEP's Credit Agreement, which totals \$491 million and is secured by Mortgage Bonds, limits the amount of mortgage bonds that may be outstanding to no more than \$840 million. At December 31, 2009, TEP had a total of \$623 million in outstanding Mortgage Bonds, consisting of \$491 million in bonds securing the TEP Credit Agreement, and \$132 million in bonds securing the 2008 TEP Letter of Credit Facility. The \$132 million in bonds securing the TEP 2008 Letter of Credit Facility were cancelled in January 2010 when the LOC was terminated. Although the Mortgage would allow TEP to issue additional bonds, the limit imposed by the TEP Credit Agreement is more restrictive and is currently the governing limitation. See *Bond Issuances*, above.



Tax-Exempt Local Furnishing Bonds

TEP has financed a substantial portion of utility plant assets with industrial development revenue bonds issued by the Industrial Development Authorities of Pima County and Apache County. The interest on these bonds is excluded from gross income of the bondholder for federal tax purposes. This exclusion is allowed because the facilities qualify as "facilities for the local furnishing of electric energy" as defined by the Internal Revenue Code. These bonds are sometimes referred to as "tax-exempt local furnishing bonds." To qualify for this exclusion, the facilities must be part of a system providing electric service to customers within not more than two contiguous counties. TEP provides electric service to retail customers in the City of Tucson and certain other portions of Pima County, Arizona and to Fort Huachuca in contiguous Cochise County, Arizona.

TEP has financed the following facilities, in whole or in part, with the proceeds of tax-exempt local furnishing bonds: Springerville Unit 2, Sundt Unit 4, a dedicated 345-kV transmission line from Springerville Unit 2 to TEP's retail service area (the Express Line), and a portion of TEP's local transmission and distribution system in the Tucson metropolitan area. During 2008, the Pima Authority issued \$221 million of tax-exempt local furnishing bonds for TEP's benefit. See *Bond Issuances*, above.

As of December 31, 2009, TEP had approximately \$580 million of tax-exempt local furnishing bonds outstanding. Approximately \$331 million in principal amount of such bonds financed Springerville Unit 2 and the Express Line. In addition, approximately \$11 million of remaining lease debt related to the Sundt Unit 4 lease obligation was issued as tax-exempt local furnishing bonds.

In December 2008, the Arizona Department of Commerce allocated \$200 million of tax-exempt financing volume cap to TEP for purposes of financing local furnishing transmission and distribution projects in Pima County, Arizona. Any new IDBs issued under this allocation would be issued in one or more series by the Pima Authority for the benefit of TEP. TEP has until December 2011 to use this volume cap allocation. Upon receipt of this allocation in December 2008, TEP paid a \$2 million security deposit to the Arizona Department of Commerce. This security deposit is refundable on a pro rata basis after each new series of IDBs is issued.

**Capital Lease Obligations**

At December 31, 2009, TEP had \$529 million of total capital lease obligations on its balance sheet. The table below provides a summary of the outstanding lease amounts in each of the obligations.

Leased Asset	Capital Lease Obligation Balance at December 31, 2009	Expiration	Renewal/Purchase Option
	- In Millions -		
Springerville Unit 1	\$ 321	2015	Fair market value purchase option
Springerville Coal Handling Facilities	85	2015	Fixed price purchase option of \$120 million
Springerville Common Facilities	110	2017 & 2021	Fixed price purchase option of \$106 million
Sundt Unit 4	13	2011	Agreement to purchase equity entered into January 2010
Total Capital Lease Obligations	\$ 529		

In January 2010, TEP entered into an agreement to purchase 100% of the equity interest in Sundt Unit 4. See *Sundt Unit 4*, above, for more information.

Except for Sundt Unit 4, TEP's 14% equity ownership in the Springerville Unit 1 Leases and its 13% equity ownership in the Springerville Coal Handling Facilities, TEP will not own these assets at the expiration of the leases. The renewal and purchase option for Springerville Unit 1 is for fair market value as determined at that time, while the purchase price option is fixed for the Springerville Coal Handling Facilities and Common Facilities.



TEP's capital lease obligation balances decline over time due to the normal capital lease payments made by TEP. See *Note 6. Debt, Credit Facilities and Capital Lease Obligations* for more information about the fixed purchase price amounts.

The following chart displays TEP's contractual obligations as of December 31, 2009 by maturity and by type of obligation.

**TEP's Contractual Obligations**  
**- Millions of Dollars -**

Payment Due in Years Ending December 31,	2010	2011	2012	2013	2014	2015 and after	Other	Total
<b>Long Term Debt</b>								
Principal	\$ —	\$ 494	\$ —	\$ —	\$ —	\$ 445	\$ —	\$ 939
Interest	39	38	34	34	34	484	—	663
Capital Lease Obligations	93	107	118	123	195	103	—	739
Operating Leases	1	—	—	—	—	—	—	1
<b>Purchase Obligations:</b>								
Fuel (including Transportation)	89	51	42	39	37	142	—	400
Purchased Power	44	12	4	2	2	2	—	66
Transmission	2	2	2	2	2	2	—	12
<b>Other Long-Term Liabilities:</b>								
Pension & Other Post Retirement Obligations	26	5	5	6	6	30	—	78
Acquisition of Springerville Coal Handling and Common Facilities	—	—	—	—	—	226	—	226
Unrecognized Tax Benefits	—	—	—	—	—	—	19	19
<b>Total Contractual Cash Obligations</b>	<b>\$ 294</b>	<b>\$ 709</b>	<b>\$ 205</b>	<b>\$ 206</b>	<b>\$ 276</b>	<b>\$ 1,434</b>	<b>\$ 19</b>	<b>\$3,143</b>

See *UniSource Energy Consolidated, Liquidity and Capital Resources, Contractual Obligations*, above, for a description of these obligations.

We have reviewed our contractual obligations and provide the following additional information:

- TEP's Credit Agreement contains pricing based on TEP's credit ratings. A change in TEP's credit ratings can cause an increase or decrease in the amount of interest TEP pays on its borrowings, and the amount of fees it pays for its letters of credit and unused commitments. A downgrade in TEP's credit ratings would not cause a restriction in TEP's ability to borrow under its revolving credit facility.
- TEP's Credit Agreement contains certain financial and other restrictive covenants, including interest coverage and leverage tests. Failure to comply with these covenants would entitle the lenders to accelerate the maturity of all amounts outstanding. At December 31, 2009, TEP was in compliance with these covenants. See *TEP Credit Agreement* above.
- TEP conducts its wholesale marketing and risk management activities under certain master agreements whereby TEP may be required to post credit enhancements in the form of cash or a letter of credit due to exposures exceeding unsecured credit limits provided to TEP, changes in contract values, a change in TEP's credit ratings or if there has been a material change in TEP's creditworthiness. As of December 31, 2009, TEP had posted a \$1 million letter of credit as collateral with counterparties for credit enhancement.

**Dividends on Common Stock**

TEP declared and paid dividends to UniSource Energy of \$60 million in 2009, \$3 million in 2008, and \$53 million in 2007.

TEP can pay dividends if it maintains compliance with the TEP Credit Agreement and certain financial covenants. As of December 31, 2009, TEP was in compliance with the terms of the TEP Credit 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 that 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 \$7 million in 2009, \$9 million in 2008, and \$4 million in 2007. We expect operations at UNS Gas to vary with the seasons, with peak energy usage occurring in the winter months.

The table below provides summary financial information for UNS Gas.

	<u>2009</u>	<u>2008</u>	<u>2007</u>
	-Millions of Dollars-		
Gas Revenues	\$ 149	\$ 172	\$ 149
Other Revenues	4	2	2
<b>Total Operating Revenues</b>	<u>153</u>	<u>174</u>	<u>151</u>
Total Purchased Gas and PGA Expense	99	117	101
Other Operations and Maintenance Expense	25	25	27
Depreciation and Amortization	7	7	8
Taxes other than Income Taxes	3	3	3
<b>Total Other Operating Expenses</b>	<u>134</u>	<u>152</u>	<u>139</u>
<b>Operating Income (Loss)</b>	<u>18</u>	<u>22</u>	<u>12</u>
Total Interest Expense	6	7	7
Total Other Income	—	—	2
Income Tax Expense (Benefit)	5	6	3
<b>Net Income (Loss)</b>	<u>\$ 7</u>	<u>\$ 9</u>	<u>\$ 4</u>

The table below shows UNS Gas' therm sales and revenues for 2009, 2008 and 2007.

	<u>Gas Sales (Millions of Therms)</u>				<u>Gas Revenues (Millions of Dollars)</u>			
	<u>2009</u>	<u>2008</u>	<u>09-08 %Chng</u>	<u>2007</u>	<u>2009</u>	<u>2008</u>	<u>09-08 % Chng</u>	<u>2007</u>
<b>Retail Therm Sales:</b>								
Residential	70	72	(3.4%)	71	\$ 91	\$ 97	(6.5%)	\$ 90
Commercial	30	31	(4.4%)	31	32	36	(9.1%)	34
Industrial	2	2	15.4%	2	2	2	7.6%	2
Public Authorities	6	7	(7.7%)	8	7	8	(11.4%)	7
<b>Total Retail Therm Sales</b>	<u>108</u>	<u>112</u>	<u>(3.6%)</u>	<u>112</u>	<u>132</u>	<u>143</u>	<u>(7.3%)</u>	<u>133</u>
Transport	36	40	(7.0%)	25	4	4	(2.7%)	3
Negotiated Sales Program (NSP)	30	32	(7.7%)	19	13	25	(48.7%)	13
<b>Total Therm Sales</b>	<u>174</u>	<u>184</u>	<u>(5.1%)</u>	<u>156</u>	<u>\$ 149</u>	<u>\$ 172</u>	<u>(13.1%)</u>	<u>\$ 149</u>

Retail therm sales in 2009 decreased by 3.6% compared with 2008 due to mild weather and weak economic conditions. Heating degree days were down 3% compared with 2008 and use per customer also decreased. Economic conditions have resulted in lower customer growth rates than experienced in prior years. As of December 31, 2009, UNS Gas had approximately 145,000 retail customers, which represents an increase of less than 1% compared with year end 2008. The lower gas sales volumes resulted in an \$11 million, or 7.3%, decrease in retail revenues.



Through a Negotiated Sales Program (NSP) approved by the ACC, UNS Gas supplies natural gas to some of its large transportation customers. 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 Purchased Gas Adjustor (PGA) mechanism which reduces the gas commodity price. See *Factors Affecting Results of Operations, Rates and Regulation, Energy Cost Adjustment Mechanism*, below.

## FACTORS AFFECTING RESULTS OF OPERATIONS

### Rates

#### Energy Cost Adjustment Mechanism

UNS Gas' retail rates include a PGA mechanism 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 from 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 twelve month period. In 2007, the ACC increased the annual cap on the maximum increase in the PGA factor from \$0.10 per therm to \$0.15 per therm in a twelve month period.

At any time UNS Gas' 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 so that the ACC can determine how the over-collected balance should be returned to customers. On December 31, 2009, the PGA bank balance was over-collected by \$10 million. In October 2009, the ACC approved a \$0.08 cent per therm PGA surcredit, effective November 2009 through October 2010 or until the balance reaches zero.

#### 2008 General Rate Case Filing

Due to increases in capital and operating costs related to providing safe and reliable service to customers of UNS Gas, UNS Gas believes the rates approved by the ACC in 2007 are inadequate for UNS Gas to recover its costs and earn a reasonable return on its investments.

In November 2008, UNS Gas filed a general rate case with the ACC on a cost of service basis. Below is a table that summarizes UNS Gas' request:

Test year — 12 months ended June 30, 2008	Requested by UNS Gas
Original cost rate base	\$182 million
Revenue deficiency	\$9.5 million
Total rate increase (over test year revenues)	6%
Cost of long-term debt	6.5%
Cost of equity	11.0%
Actual capital structure	50% equity / 50% debt
Weighted average cost of capital	8.75%
Rate of return on fair value rate base	6.80%

In June 2009, ACC staff recommended a rate increase of \$3.4 million based on an original cost rate base of \$178 million and a 10% return on equity. Hearings before the ALJ concluded in August 2009. UNS Gas expects the ACC to issue a final order in the first half of 2010. UNS Gas cannot predict the outcome of this general rate case proceeding.

**Fair Value Measurements**

UNS Gas adopted fair value measurements, on January 1, 2008. See *Tucson Electric Power , Factors Affecting Results of Operations* , above, for more information about fair value measurements.

The following table sets forth, by level within the fair value hierarchy, UNS Gas' financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2009. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

**UNS Gas**  
**December 31, 2009**  
- Millions of Dollars -

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Cash Equivalents <sup>(1)</sup>	\$ 25	\$ —	\$ —	\$ 25
Cash Collateral <sup>(2)</sup>	—	2	—	2
Energy Contracts <sup>(3)</sup>	—	(7)	—	(7)
Total	<u>\$ 25</u>	<u>\$ (5)</u>	<u>\$ —</u>	<u>\$ 20</u>

- (1) Cash Equivalents are based on observable market prices and are comprised of the fair value of money market funds and certificates of deposit.
- (2) Collateral provided to energy contract counterparties to reduce credit risk exposure.
- (3) Energy contracts include gas swap agreements (Level 2) entered into to take advantage of favorable market conditions and reduce exposure to energy price risk. The amounts include current and non-current assets and are net of current and non-current liabilities.

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

UNS Gas' capital requirements consist primarily of capital expenditures. In 2009, capital expenditures were \$13 million. UNS Gas expects internal cash flows to fund its future operating activities and a large portion of its construction expenditures. 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 revolving credit facility, additional credit lines, the issuance of long-term debt, or capital contributions from UniSource Energy. The rate increase approved by the ACC in November 2007 covers some, but not all, of UNS Gas' higher costs and capital investments.

**Operating Cash Flow and Capital Expenditures**

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

	<u>2009</u>	<u>2008</u>	<u>2007</u>
	-Millions of Dollars-		
Cash provided by (used in):			
Operating Activities	37	\$ 3	\$ 28
Investing Activities	(13)	(16)	(22)
Financing Activities	—	1	(6)
Net Increase (Decrease) in Cash	24	(12)	—
Beginning Cash	7	19	19
Ending Cash	<u>31</u>	<u>7</u>	<u>19</u>

Operating cash flows increased in 2009 due to a net over-recovery of PGA gas costs and cash inflows related to the return of cash collateral deposited in prior periods with gas supply and hedging counterparties.

Forecasted capital expenditures for UNS Gas are as follows:

	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
	- Millions of Dollars -				
UNS Gas	\$ 14	\$ 16	\$ 16	\$ 16	\$ 18

**UNS Gas/UNS Electric Revolver**

The UNS Gas/UNS Electric Revolver is a \$60 million unsecured revolving credit facility which matures in August 2011. Either borrower may borrow up to a maximum of \$45 million so long as the combined amount borrowed does not exceed \$60 million.

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. UES guarantees the obligations of both UNS Gas and UNS Electric.

UNS Gas and UNS Electric have the option of paying interest on borrowings at LIBOR plus 1.0% or the greater of the federal funds rate plus 0.5% or the agent bank's reference rate. Letter of credit fees are 1.0% per annum.

The UNS Gas/UNS Electric Revolver contains restrictions on additional indebtedness, liens, dividends, mergers and sales of assets; it also contains a maximum leverage ratio and a minimum cash flow to interest coverage ratio for each borrower. As of December 31, 2009, UNS Gas and UNS Electric were each in compliance with the terms of the UNS Gas/UNS Electric Revolver.

If an event of default occurs, the UNS Gas/UNS Electric Revolver may become immediately due and payable. An event of default includes failure to make required payments under the UNS Gas/UNS Electric Revolver, certain change in control transactions, certain bankruptcy events of UNS Gas or UNS Electric, or failure of UES, UNS Gas or UNS Electric to make payments or default on debt greater than \$4 million.

UNS Gas 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 natural gas procurement and hedging activities. As of February 23, 2010, UNS Gas had no outstanding letters of credit under the UNS Gas/UNS Electric Revolver.

**Interest Rate Risk**

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. As a result of recent volatility in interest rates, UNS Gas may be required to pay higher rates of interest on borrowings under its revolving credit facility. See *Item 7A. Quantitative and Qualitative Disclosures about Market Risk, Credit Risk*, below.

**Senior Unsecured Notes**

UNS Gas has \$100 million of 6.23% senior unsecured notes outstanding of which \$50 million matures in 2011 and \$50 million matures in 2015. These notes are guaranteed by UES. The note purchase agreement for UNS Gas restricts transactions with affiliates, mergers, liens, restricted payments and incurrence of indebtedness, and also contains a minimum net worth test. As of December 31, 2009, UNS Gas was in compliance with the terms of its note purchase agreement.

UNS Gas must meet a leverage test and an interest coverage test to issue additional debt or to pay dividends. However, UNS Gas may, without meeting these tests, refinance existing debt and incur up to \$7 million in short-term debt.

**Contractual Obligations**UNS Gas Supply Contracts

UNS Gas directly manages its gas supply and transportation contracts. The market price for gas varies based upon the period during which the commodity is purchased. UNS Gas has firm transportation agreements with capacity sufficient to meet its current load requirements. These contracts expire in various years between 2011 and 2023. These costs are passed through to UNS Gas' customers via the PGA.

UNS Gas hedges its gas supply prices by entering into fixed price forward contracts and financial swaps at various times during the year to provide more stable prices to its customers. These purchases and hedges are made up to three years in advance with the goal of hedging at least 45% of the expected monthly gas consumption with fixed prices prior to entering into the month. UNS Gas hedged approximately 45% of its expected monthly consumption for the 2009/2010 winter season (November through March). Additionally, UNS Gas has approximately 40% of its expected gas consumption hedged for April through October 2010, and 35% hedged for the period November 2010 through March 2011.

The following table displays UNS Gas' contractual obligations as of December 31, 2009 by maturity and by type of obligation.

**UNS Gas' Contractual Obligations**  
-Millions of Dollars-

Payment Due in Years Ending December 31,	2010	2011	2012	2013	2014	2015 and after	Total
<b>Long Term Debt</b>							
Principal	\$ —	\$ 50	\$ —	\$ —	\$ —	\$ 50	\$ 100
Interest	6	6	3	3	3	4	25
<b>Purchase Obligations —</b>							
Fuel	19	14	5	3	3	23	67
<b>Pension &amp; Other Post</b>							
Retirement Obligations	1	—	—	—	—	—	1
<b>Total Contractual Cash</b>							
Obligations	<u>\$ 26</u>	<u>\$ 70</u>	<u>\$ 8</u>	<u>\$ 6</u>	<u>\$ 6</u>	<u>\$ 77</u>	<u>\$ 193</u>

UNS Gas conducts certain of its gas procurement and risk management activities under certain agreements whereby UNS Gas may be required to post margin due to changes in contract values, a change in UNS Gas' creditworthiness or exposures exceeding credit limits provided to UNS Gas. As of December 31, 2009, UNS Gas had posted \$2 million in such credit enhancements.

**Dividends on Common Stock**

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 December 31, 2009, UNS Gas was in compliance with the terms of its note purchase agreement. See *Senior Unsecured Notes*, above.



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

UNS Electric reported net income of \$6 million in 2009, \$4 million in 2008 and \$5 million in 2007. Similar to TEP's operations, we expect UNS Electric's operations to be seasonal in nature, with peak energy demand occurring in the summer months.

The table below provides summary financial information for UNS Electric.

	2009	2008	2007
	-Millions of Dollars-		
Retail Electric Revenues	\$ 180	\$ 183	\$ 165
Wholesale Electric Revenues	5	10	—
Other Revenues	2	2	4
Total Operating Revenues	187	195	169
Purchased Energy and Fuel Expense	128	143	118
Other Operations and Maintenance Expense	25	22	23
Depreciation and Amortization	14	14	13
Taxes other than Income Taxes	4	4	3
Total Other Operating Expenses	171	183	157
Operating Income	16	12	12
Total Other Income	1	1	2
Total Interest Expense	7	7	6
Income Tax Expense	4	2	3
<b>Net Income</b>	<b>\$ 6</b>	<b>\$ 4</b>	<b>\$ 5</b>

The table below shows UNS Electric's kWh sales and revenues for 2009, 2008 and 2007.

	Electric Sales - Millions of kWh				Electric Revenues - Millions of Dollars			
	2009	2008	09-08 %Chng	2007	2009	2008	09-08 %Chng	2007
<b>Electric Retail Sales:</b>								
Residential	814	822	(1.1%)	854	\$ 82	\$ 92	(10.6%)	\$ 86
Commercial	608	620	(1.9%)	627	63	70	(9.9%)	64
Industrial	197	189	4.2%	199	17	17	(2.2%)	15
Mining	163	30	NM	—	12	3	NM	—
Other	2	2	(0.8%)	2	—	—	—	—
<b>Total Electric Retail Sales</b>	<b>1,784</b>	<b>1,663</b>	<b>7.3%</b>	<b>1,682</b>	<b>\$ 174</b>	<b>\$ 182</b>	<b>(4.4%)</b>	<b>\$ 165</b>
REST & DSM	—	—	—	—	6	1	NM	—
Wholesale Electric Sales	154	153	(0.5%)	—	5	10	NM	—
<b>Total Electric Sales</b>	<b>1,938</b>	<b>1,816</b>	<b>6.7%</b>	<b>1,682</b>	<b>\$ 185</b>	<b>\$ 193</b>	<b>(4.0%)</b>	<b>\$ 165</b>

In 2009, retail kWh sales increased by 7.3% compared to 2008. The increase is due primarily to increased usage by a new copper mining customer in UNS Electric's service area. Excluding mining sales, UNS Electric's retail kWh sales decreased by 0.8% compared with last year as a result of weak economic conditions.

UNS Electric's retail customer base did not increase during 2009. As of December 31, 2009, UNS Electric had approximately 90,000 retail customers, which is comparable with the prior year.

Wholesale revenues decreased by \$5 million in 2009 due to lower market prices for wholesale power. Wholesale sales are made primarily from contract and resource capacity agreements that became effective June 1, 2008, subsequent to the expiration of UNS Electric's full requirements contract with Pinnacle West Marketing and Trading (PWMT). All revenues from wholesales sales are credited against costs recovered through UNS Electric's PPFAC.

## FACTORS AFFECTING RESULTS OF OPERATIONS

### Competition

As required by the ACC order approving UniSource Energy's acquisition of the Citizens' Arizona gas and electric assets, in 2003 UNS Electric filed with the ACC a plan to open its service territories to retail competition by December 31, 2003. The plan is subject to review and approval by the ACC, which has not yet considered the plan. As a result of the court decisions concerning the ACC's Rules, we are unable to predict when and how the ACC will address this plan. See *Item 1. — Business, TEP, Rates and Regulation, Retail Electric Competition Rules*, for more information.

### Rates

#### 2008 UNS Electric Rate Order

In May 2008, the ACC issued an order authorizing a 2.5%, or \$4 million base rate increase effective June 1, 2008. UNS Electric had requested a 5.5%, or \$8.5 million base rate increase.

#### Purchased Power and Fuel Adjustment Clause

As part of the 2008 ACC order, a new PPFAC mechanism took effect on June 1, 2008. The PPFAC mechanism has a forward component and a true-up component. The forward component of the PPFAC rate is based on forecasted fuel and purchased power costs. The true-up component reconciles actual fuel and purchased power costs with the amounts collected in the prior year and any amounts under/over-collected will be collected/credited from/to customers. The ACC approved a cap on the PPFAC forward component of 1.73 cents per kWh, resulting in total fuel and purchased power recovery of approximately 8.7 cents per kWh, an increase of approximately 1.7 cents per kWh in UNS Electric's average retail rate. On April 1, 2009, UNS Electric filed a request with the ACC for a PPFAC rate that credits 1.06 cents per kWh. This results in a total fuel and purchased power recovery of approximately 6.06 cents per kWh that became effective on June 1, 2009.

#### 2009 General Rate Case Filing

On April 30, 2009, UNS Electric filed a rate case application with the ACC seeking a base rate increase of 7.4% or \$13.5 million. UNS Electric's filing also included a proposal to acquire, and put into its rate base, BMGS, the gas-fired facility in UNS Electric's service territory that is owned and operated by UED. The proposed acquisition and inclusion of BMGS in rate base would not impact the amount of the total rate increase requested by UNS Electric. The ACC staff testimony recommended a base revenue increase of approximately \$8 million. A hearing before an ACC administrative law judge concluded in February 2010.

### Electric Energy Efficiency Standards

In December 2009, the ACC established a process to adopt new Electric Energy Efficiency Standards (EE Standards) designed to require UNS Electric, TEP and other affected utilities to implement DSM programs, only to the extent that they are cost effective. The proposed EE Standards target cost effective total kWh savings in 2011 of 1.25% and ramping up each year to reach a targeted cumulative annual reduction in retail kWh sales of 22% by 2020. Savings from Direct Load Control programs, previously implemented DSM programs and from a portion of energy efficient building codes may be counted towards meeting the target. The proposed EE Standards provide for recovery of costs incurred to implement cost effective DSM programs. UNS Electric's DSM programs and rates charged to customers for such programs are subject to ACC approval. If the ACC approves EE Standards, they must be certified by the Arizona Attorney General before taking affect.

### Purchased Power Agreement

In May 2008, UNS Electric and UED entered into a Power Purchase and Sales Agreement (PPA) under which UED sells all the output of the 90 MW gas-fired Black Mountain Generating Station (BMGS) to UNS Electric over a five-year term. The PPA is a tolling arrangement in which UNS Electric takes operational control of BMGS and assumes all risk of operation and maintenance costs, including fuel. Under the terms of the PPA, UNS Electric pays UED a capacity charge. The costs associated with the PPA are recoverable through UNS Electric's PPFAC.

## Renewable Energy Standard and Tariff

UNS Electric began implementing its ACC approved REST plan on June 1, 2008. In 2009 and 2008, UNS Electric collected \$5 million and \$3 million in REST surcharges, of which \$6 million and \$1 million were expensed for REST projects, respectively. Any surcharge collections above or below the amount of renewable expenditures will be deferred and reflected in UNS Electric's financial statements as a regulatory liability or asset. In 2010, UNS Electric expects to collect \$8 million from customers through the REST surcharge. REST implementation plans and the associated surcharge must be submitted annually to the ACC for review and approval. For more information, see *Item 1. Business, UNS Electric, Renewable, Energy Standard and Tariff*, above.

## Fair Value Measurements

UNS Electric adopted fair value measurements on January 1, 2008. See *Tucson Electric Power, Factors Affecting Results of Operations*, above, for more information about fair value measurements.

The following table sets forth, by level within the fair value hierarchy, UNS Electric's financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2009. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

**UNS Electric**  
**December 31, 2009**  
- Millions of Dollars -

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Cash Equivalents <sup>(1)</sup>	\$ 9	\$ —	\$ —	\$ 9
Energy Contracts <sup>(2)</sup>	—	(3)	(9)	(12)
<b>Total</b>	<b>\$ 9</b>	<b>\$ (3)</b>	<b>\$ (9)</b>	<b>\$ (3)</b>

- (1) Cash Equivalents are based on observable market prices and are comprised of the fair value of money market funds and certificates of deposit.
- (2) Energy contracts include gas swap agreements (Level 2), forward power purchase and sales contracts (Level 3), and forward power purchase contracts indexed to gas (Level 3), entered into to take advantage of favorable market conditions and reduce exposure to energy price risk. The amounts include current and non-current assets and are net of current and non-current liabilities. The level 3 valuation techniques are described below.

UNS Electric recorded in 2009, net unrealized gains of \$7 million in net Regulatory Assets due to the change in the fair value of forward power purchase contracts classified as Level 3 in the fair value hierarchy. These changes in fair value were primarily due to older fixed price contracts settling during the year and entering into new fixed price forward power contracts at lower prices.

UNS Electric's Level 3 derivatives include certain energy contracts where published prices are not readily available. These include contracts for delivery periods during non-standard time blocks, contracts for delivery during only a few months of a given year when prices are quoted only for the annual average, or contracts for delivery at illiquid delivery points. In these cases, UNS Electric applies certain management assumptions to value such contracts. These assumptions include applying percentage multipliers to value non-standard time blocks, applying historical price curve relationships to calendar year quotes, and including adjustments for transmission and line losses to value contracts at illiquid delivery points. 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. UNS Electric reviews these assumptions on a quarterly basis.

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

In 2009, UNS Electric's capital expenditures were \$28 million. UNS Electric expects internal cash flows to fund a portion of its construction expenditures. 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. In April 2007, UniSource Energy contributed \$10 million of capital to UNS Electric.

UNS Electric implemented an average base rate increase of approximately 2.5% in June 2008, however the increase does not provide sufficient cash flow to cover UNS Electric's higher costs and fund all of its capital expenditures. UNS Electric may need to rely more heavily on external funding sources for capital expenditures until it receives a decision in the rate case filed in April 2009. See *UniSource Energy Consolidated, Outlook and Strategies, Economic Conditions and UniSource Energy Consolidated, Liquidity and Capital Resources, Liquidity, Access to Revolving Credit Facilities*, above for more information regarding the potential impact of current financial market conditions.

In August 2008, UNS Electric issued \$100 million of unsecured debt. A portion of the proceeds was used to redeem \$60 million of notes that matured on August 11, 2008. The remaining proceeds were used to repay outstanding borrowings by UNS Electric under the UNS Gas/UNS Electric Revolver and for general corporate purposes. See *Senior Unsecured Notes*, below.

**Operating Cash Flow and Capital Expenditures**

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

	<u>2009</u>	<u>2008</u>	<u>2007</u>
	-Millions of Dollars-		
Cash provided by (used in):			
Operating Activities	\$ 37	\$ 14	\$ 22
Investing Activities	(28)	(30)	(36)
Financing Activities	(8)	22	12
Net Increase (Decrease) in Cash	1	6	(2)
Beginning Cash	9	3	5
Ending Cash	<u>10</u>	<u>9</u>	<u>3</u>

Operating cash flows increased in 2009 because of the higher mining kWh sales, an increase in base rates, and the PPFAC charge that went into effect on June 1, 2008.

Forecasted capital expenditures for UNS Electric are as follows:

	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
	- Millions of Dollars -				
UNS Electric	\$ 26	\$ 25	\$ 31	\$ 13	\$ 16

**UNS Gas/UNS Electric Revolver**

See *UNS Gas, Liquidity and Capital Resources, UNS Gas/UNS Electric Revolver* above for 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. At February 23, 2010, UNS Electric had \$12 million outstanding under the UNS Gas/UNS Electric Revolver.

**Senior Unsecured Notes**

UNS Electric has \$100 million of senior unsecured notes outstanding, consisting of \$50 million of 6.50% notes due in 2015 and \$50 million of 7.10% notes due August 2023. The notes are guaranteed by UES. The note purchase agreement for UNS Electric contains certain restrictive covenants, including restrictions on transactions with affiliates, mergers, liens to secure indebtedness, restricted payments, and incurrence of indebtedness. As of December 31, 2009, UNS Electric was in compliance with the terms of its note purchase agreement.

UNS Electric must meet a leverage test and an interest coverage test to issue additional debt or to pay dividends. However, UNS Electric may, without meeting these tests, refinance existing debt and incur up to \$5 million in short-term debt.

**Contractual Obligations**UNS Electric Power Supply and Transmission Contracts

UNS Electric enters into various power supply agreements for periods of one to five years. Certain of these contracts are at a fixed price per MW and others are indexed to natural gas prices.

UNS Electric's power purchase contracts and risk management activities are subject to master agreements whereby UNS Electric may be required to post margin due to changes in contract values or if there has been a material change in UNS Electric's creditworthiness, or exposures exceeding credit limits provided to UNS Electric. As of December 31, 2009, UNS Electric had posted \$11 million of such credit enhancements in the form of letters of credit.

UNS Electric imports the power it purchases over the Western Area Power Administration's (WAPA) transmission lines. UNS Electric's transmission capacity agreements with WAPA provide for annual rate adjustments and expire in 2017 and 2011.

The following table displays UNS Electric's contractual obligations as of December 31, 2009 by maturity and by type of obligation.

**UNS Electric's Contractual Obligations**  
-Millions of Dollars-

Payment Due in Years Ending December 31,	2010	2011	2012	2013	2014	2015 and after	Total
<b>Long Term Debt</b>							
Principal	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 100	\$ 100
Interest	7	7	7	7	7	34	69
<b>Purchase Obligations:</b>							
Purchased Power	67	23	14	47	—	—	151
Transmission	2	2	1	—	—	—	5
<b>Pension &amp; Other Post Retirement Obligations</b>	1	—	—	—	—	—	1
<b>Total Contractual Cash Obligations</b>	<u>\$ 77</u>	<u>\$ 32</u>	<u>\$ 22</u>	<u>\$ 54</u>	<u>\$ 7</u>	<u>\$ 134</u>	<u>\$ 326</u>

**Dividends on Common Stock**

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 December 31, 2009, UNS Electric was in compliance with the terms of its note purchase agreement. See *Senior Unsecured Notes*, above. As of December 31, 2009, UNS Electric has not paid dividends to UniSource Energy. UNS Electric's ability to pay dividends will depend on the outcome of the rate case filed in April 2009, the need for capital expenditures and various other factors.

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

The table below summarizes the income (loss) for the Other non-reportable segments in the last three years.

	<u>2009</u>	<u>2008</u>	<u>2007</u>
	- Millions of Dollars -		
UniSource Energy Parent Company	\$ (6)	\$ (5)	\$ (5)
Millennium	3	—	1
UED	5	3	—
Total Other Net Loss	<u>\$ 2</u>	<u>\$ (2)</u>	<u>\$ (4)</u>

**UniSource Energy Parent Company**

UniSource Energy parent company expenses include interest expense (net of tax) related to the UniSource Energy Convertible Senior Notes and the UniSource Credit Agreement. In 2009, UniSource Energy had capital expenditures of \$8 million related to the purchase of land and site development to construct a new headquarters building.

**UED**

UED completed the construction of the 90 MW BMGS in Kingman, Arizona in May 2008. UED sells the output of BMGS to UNS Electric through a PPA. See *UNS Electric, Factors Affecting Results of Operation, Purchased Power Agreement*, above.

In December 2008, UniSource Energy contributed \$59 million of equity to UED by canceling an intercompany promissory note in the amount of \$59 million. Borrowings under the promissory note were used to finance the development of BMGS.

In March 2009, UED entered into a 364-day \$30 million term loan facility that is guaranteed by UniSource Energy and is secured by substantially all of the assets of UED, which primarily consist of BMGS and a mortgage on UED's leasehold interest in the real property on which BMGS is located. UED used the loan proceeds to pay a \$30 million dividend to UniSource Energy, which in turn made a capital contribution to TEP. UED has the option of paying interest at LIBOR plus 3% or an alternate base rate plus 2%. As of December 31, 2009, UED owed \$26 million under this term loan facility. In February 2010, UED made an additional borrowing under the facility, resulting in \$35 million of outstanding debt, and extended the maturity of the debt for two years to March 2012. The loan proceeds were used to pay a \$9 million dividend to UniSource Energy.

In 2009 and 2008, UED recorded after-tax income of \$5 million and \$3 million, respectively, related to the operation of BMGS.

In 2008, UED made distributions to UniSource Energy of less than \$1 million. The \$30 million dividend paid in 2009 represented a return of capital distribution, as did \$4 million of the \$9 million dividends paid in February 2010.

**FACTORS AFFECTING RESULTS OF OPERATIONS****Millennium Investments**

Millennium is in the process of exiting its remaining investments which may yield gains or losses. At December 31, 2009, Millennium's key assets included: a \$15 million note receivable related to the sale of Sabinas; a \$10 million investment balance in various energy technology projects; and \$7 million in cash.

In June 2009, Millennium finalized a sale of its 50% interest in Sabinas to Mimosa. The terms called for an upfront \$5 million payment to Millennium which was received in January 2009. Other key terms of the transaction include a three year, 6% interest-bearing, collateralized \$15 million note from Mimosa. In June 2009, Millennium recorded a \$6 million pre-tax gain on the sale.

Millennium made \$3 million in dividend payments to UniSource Energy in 2009, \$25 million in 2008 and \$15 million in 2007. In January 2010, Millennium made a \$4 million dividend payment to UniSource Energy. All of these dividends represented return of capital distributions. Millennium's remaining commitment for all of its investments combined is less than \$1 million, which is expected to be funded over the next one to two years.

The following table sets forth, by level within the fair value hierarchy, Millennium's financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2009. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

**December 31, 2009**  
- Millions of Dollars -

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Investments	\$ 4	\$ —	\$ 6	\$ 10

Level 1 Investments represent the fair value of money market funds based on observable market prices. Level 3 Investments represent Millennium's equity investment in unregulated businesses that, in the absence of readily ascertainable market values, is based on the investment partners' valuations.

**CRITICAL ACCOUNTING POLICIES**

In preparing financial statements under Generally Accepted Accounting Principles (GAAP), management exercises judgment in the selection and application of accounting principles, including making estimates and assumptions. UniSource Energy and TEP consider Critical Accounting Policies to be those that could result in materially different financial statement results if our assumptions regarding application of accounting principles were different. UniSource Energy and TEP describe their Critical Accounting Policies below. Other significant accounting policies and recently issued accounting standards are discussed in Note 1 of *Notes to Consolidated Financial Statements — Nature of Operations and Summary of Significant Accounting Estimates*.

**Accounting for Rate Regulation**

TEP, UNS Gas and UNS Electric generally use the same accounting policies and practices used by unregulated companies for financial reporting under GAAP. However, sometimes these principles require special accounting treatment for regulated companies to show the effect of regulation. For example, in setting retail rates for TEP, UNS Gas and UNS Electric, the ACC may not allow TEP, UNS Gas or UNS Electric to currently charge their customers to recover certain expenses, but instead may require that these expenses be charged to customers in the future. In this situation, regulatory accounting requires that TEP, UNS Gas and UNS Electric defer these items and show them as regulatory assets on the balance sheet until TEP, UNS Gas and UNS Electric are allowed to charge their customers. TEP, UNS Gas and UNS Electric then amortize these items as expense to the income statement as these charges are recovered from customers. Similarly, certain revenue items may be deferred as regulatory liabilities, which are also eventually amortized to the income statement as rates to customers are reduced.

## TEP

Upon approval by the ACC of a settlement agreement in November 1999, TEP discontinued application of regulatory accounting for its generation operations. Beginning in December 2008, as a result of the 2008 TEP rate order, TEP reapplied regulatory accounting to its generation related operations. Throughout this period, TEP continued to apply regulatory accounting to its transmission and distribution operations.

TEP's generation, transmission and distribution regulatory liabilities, net of regulatory assets, totaled \$42 million at December 31, 2009. If TEP stopped applying regulatory accounting to its remaining regulated operations, it would write off the related balances of its regulatory assets as an expense and its regulatory liabilities as income on its income statement. TEP regularly assesses whether it can continue to apply regulatory accounting to its cost-based rate regulated operations. Expectations of future recovery are generally based on orders issued by regulatory commissions or historical experience. There are no current or expected proposals or changes in the regulatory environment that impact the probability of future recovery of these assets.

## UNS Gas and UNS Electric

UNS Gas's regulatory liabilities, net of regulatory assets, totaled \$19 million at December 31, 2009. UNS Electric's regulatory liabilities, net of regulatory assets, totaled \$4 million at December 31, 2009. UNS Gas and UNS Electric regularly assess whether they can continue to apply regulatory accounting to their cost-based rate regulated operations. If UNS Gas and UNS Electric stopped applying regulatory accounting to their regulated operations, they would write off the related balances of regulatory assets as an expense and regulatory liabilities as income on their income statements. There are no current or expected proposals or changes in the regulatory environment that impact the probability of future recovery of these assets.

## **Accounting for Asset Retirement Obligations**

### TEP

TEP is required to record the fair value of a liability for a legal obligation to retire an asset in the period in which the liability is incurred. A legal obligation can also be associated with the retirement of a long-lived asset whose timing and/or method of settlement are conditional on a future event. TEP incurs legal obligations as a result of environmental and other governmental regulations, contractual agreements and other factors. To estimate the liability, management must use significant judgment and assumptions in: determining whether a legal obligation exists to remove assets; estimating the probability of a future event for a conditional obligation; estimating the fair value of the cost of removal; estimating when final removal will occur; and estimating the credit-adjusted risk-free interest rates to be used to discount the future liabilities. Changes that may arise over time with regard to these assumptions and determinations will change amounts recorded in the future as expense for asset retirement obligations.

The initial liability is recorded by increasing the carrying amount of the related long-lived asset. Over time, the liability is adjusted to its present value by recognizing accretion expense as an operating expense in the income statement each period, and the capitalized cost of the long-lived asset is depreciated over the useful life of the related asset. Upon settlement of the liability, TEP will pay the recorded liability or incur a gain or loss if the actual costs differ from the recorded amount. If TEP retires any asset at the end of its useful life, without a legal obligation to do so, TEP will record retirement costs at that time as incurred or accrued.

TEP has identified legal obligations to retire generation plant assets specified in land leases for its jointly-owned Navajo and Four Corners Generating Stations. The land on which these stations reside is leased from the Navajo Nation. The provisions of the leases require the lessees to remove the facilities upon request of the Navajo Nation at the expiration of the leases. TEP also has certain environmental obligations at the San Juan Generating Station. TEP has estimated that its share of the cost to remove the Navajo and Four Corners facilities and settle the San Juan environmental obligations will be approximately \$40 million at the date of retirement. No other legal obligations to retire generation plant assets were identified.

In 2004, TEP, Phelps Dodge Energy Services, LLC and PNM Resources, Inc. each purchased from Duke Energy North America, LLC a one-third interest in a limited liability company which owns the natural gas-fired Luna Energy Facility (Luna) in Southern New Mexico. Luna is a 570-MW combined cycle plant and was placed into commercial operation in April 2006. See *Item 1. — Business, TEP, Generating and Other Resources, Future Generating Resources*. The new owners assumed asset retirement obligations to remove certain piping and evaporation ponds and to restore the ground to its original condition. TEP has estimated its share of the obligations will be approximately \$2 million at the date of retirement.



As of December 31, 2009, TEP had a liability of \$5 million associated with its final asset retirement obligations.

TEP has various transmission and distribution lines that operate under leases and rights-of-way that contain end dates and restrictive clauses. TEP operates its transmission and distribution lines as if they will be operated in perpetuity and would continue to be used or sold without land remediation. As such there are no legal obligations that require application of the accounting requirements for asset retirement obligations. Nevertheless, included in the revenue requirement underlying the Company's electric service rates is a component of depreciation expense intended to enable TEP to accrue for such future costs of retiring assets for which no legal obligations exists. The accumulated balance of such accruals, less actual removal costs incurred, net of salvage proceeds realized, is reported as a regulatory liability. As of December 31, 2009, such liability is reported as \$163 million.

#### UNS Gas and UNS Electric

UNS Gas and UNS Electric have various transmission and distribution lines that operate under land leases and rights-of-way that contain end dates and restorative clauses. UNS Gas and UNS Electric operate their transmission and distribution lines as if they will be operated in perpetuity and would continue to be used or sold without land remediation. As a result, UNS Gas and UNS Electric are not recognizing the cost of final removal of the transmission and distribution lines in the financial statements .

For the net cost of removal for interim retirements from transmission, distribution and general plant, UNS Gas accrued \$20 million as of December 31, 2009. UNS Electric accrued \$12 million as of December 31, 2009. The amounts are recorded as regulatory liabilities.

#### **Pension and Other Postretirement Benefit Plan Assumptions**

We record plan assets, obligations, and expenses related to pension and other postretirement benefit plans based on actuarial valuations, which include key assumptions on discount rates, expected returns on plan assets, compensation increases and health care cost trend rates. These actuarial assumptions are reviewed annually and modified as appropriate. The effect of modifications is generally recorded or amortized over future periods. We believe that the assumptions used in recording obligations under the plans are reasonable based on prior experience, market conditions and the advice of plan actuaries.

#### TEP

TEP is required to recognize the underfunded status of its defined benefit pension and other postretirement plans as a liability. The underfunded status is measured as the difference between the fair value of the plans assets and the projected benefit obligation for pension plans or accumulated postretirement benefit obligation for other postretirement benefit plans. We expect volatility in the liability recognized in the balance sheet in future years as the funded status of our plans can change significantly due to discount rate changes and investment and actuarial experience. TEP recorded the underfunded amount at December 31, 2009 of \$58 million for its pension obligations and \$69 million for its other post-retirement obligations as a liability and a regulatory asset to reflect expected recovery of pension and other post-retirement costs through rates.

TEP is required to measure the funded status of its pension plans as of the date of its year-end balance sheet, beginning with the year ended December 31, 2008. On January 1, 2008, TEP recorded a reduction to retained earnings of less than \$1 million to move the measurement date from December 1 to December 31 for all of its pension and other postretirement plans.

TEP discounted its future pension plan obligations at 6.3% at December 31, 2009 and its other postretirement plan obligations at a rate of 6%. TEP determines the discount rate annually based on the rates currently available on high-quality, non-callable, long-term bonds. TEP looks to bonds that receive one of the two highest ratings given by a recognized rating agency whose future cash flows match the timing and amount of expected future benefit payments. For TEP's pension plans, a 25-basis point change in the discount rate would increase or decrease the projected benefit obligation (PBO) by approximately \$7 million and the 2010 plan expense by \$1 million. For TEP's other postretirement benefit plan, a 25-basis point change in the discount rate would increase or decrease the accumulated postretirement benefit obligation (APBO) by approximately \$2 million. A 25-basis point change in the discount rate would impact plan expense by less than \$1 million.

TEP calculates the market-related value of plan assets using the fair value of plan assets on the measurement date. TEP assumed that its plans' assets would generate a long-term rate of return of 7.5% at December 31, 2009. In establishing its assumption as to the expected return on plan assets, TEP reviews the plans' asset allocation and develops return assumptions for each asset class based on advice from an investment consultant and the plans' actuary that includes both historical performance analysis and forward looking views of the financial markets. Pension expense decreases as the expected rate of return on plan assets increases. A 25-basis point change in the expected return on plan assets would impact pension expense in 2010 by less than \$1 million.

TEP used a current year health care cost trend rate of 7.9% in valuing its postretirement benefit obligation at December 31, 2009. This rate reflects both market conditions and the plan's experience. Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one-percentage point change in assumed health care cost trend rates would change the postretirement benefit obligation by approximately \$5 million and the related plan expense in 2010 by less than \$1 million.

TEP will record pension expense of approximately \$12 million and other postretirement benefit expense of \$5 million ratably through 2010, of which approximately \$2 million will be capitalized. TEP expects to make pension plan contributions of \$20 million in 2010. In 2009, TEP established a Voluntary Employee Beneficiary Association (VEBA) to fund its other postretirement benefit plan. TEP expects to make benefit payments to retirees under the postretirement benefit plan of approximately \$5 million in 2010 and contributions to the VEBA trust of \$1 million in 2010.

#### UNS Gas and UNS Electric

UNS Gas and UNS Electric discounted their future pension plan obligations using a rate of 6.3% at December 31, 2009. For UNS Gas and UNS Electric's pension plan, a 25-basis point change in the discount rate would impact the benefit obligation and 2010 pension expense by less than \$1 million. UNS Gas and UNS Electric will record pension expense of \$2 million in 2010, of which less than \$1 million will be capitalized. UNS Gas and UNS Electric expects to make combined pension plan contributions of \$2 million in 2010.

UNS Gas and UNS Electric discounted their other postretirement plan obligations using a rate of 6% at December 31, 2009. UNS Gas and UNS Electric will record postretirement medical benefit expense and make benefit payments to retirees under the postretirement benefit plan of less than \$1 million in 2010.

### **Accounting for Derivative Instruments, Trading Activities and Hedging Activities**

#### Commodity Derivative Contracts

TEP, UNS Electric and UNS Gas enter into forward contracts to purchase or sell a specified amount of capacity or energy at a specified price over a given period of time, typically for one month, three months, or one year, within established limits to take advantage of favorable market opportunities. In general, TEP enters into forward purchase contracts when market conditions provide the opportunity to purchase energy for its load at prices that are below the marginal cost of its supply resources or to supplement its own resources (e.g., during plant outages and summer peaking periods). TEP enters into forward sales contracts when it forecasts that it has excess supply and the market price of energy exceeds its marginal cost. TEP and UNS Gas also enter into forward gas commodity price swap agreements to lock in fixed prices on a portion of forecasted summer gas purchases.

As a result of the 2008 TEP Rate Order, which permits recovery in the PPFAC of hedging transactions, unrealized gains and losses on commodity derivative contracts entered into for retail customer load are recorded as either a regulatory asset or regulatory liability. UNS Electric and UNS Gas are also permitted to record unrealized gains and losses on commodity derivative contracts as either a regulatory asset or regulatory liability. There are no current or expected proposals or changes in the regulatory environment that impact the probability of future recovery of these assets through the PPFAC or PGA mechanisms.

### Interest Rate Swaps

TEP hedges the cash flow risk associated with unfavorable changes in the variable interest rates related to LIBOR on the Springerville Common Facilities Lease. TEP entered into swaps that had the effect of converting approximately \$30 million and \$35 million of variable rate lease debt payments for the Springerville Common Facilities Lease to a fixed rate from May 2009 through July 1, 2014, and June 2006 through January 2, 2020, respectively. In August 2009, TEP entered into a swap that had the effect of converting \$50 million of variable rate industrial development bonds to a fixed rate from September 2009 through September 2014. At December 31, 2009, the fair value of these interest rate swaps is a liability of \$6 million.

### Commodity Cash Flow Hedge

TEP hedges the cash flow risk associated with a six-year power wholesale supply agreement using a six-year power purchase swap agreement. Unrealized gains and losses are recorded in Accumulated Other Comprehensive Income (AOCI). At December 31, 2009, the fair value of this contract is a liability of \$1 million.

The market prices used to determine fair values for TEP, UNS Electric and UNS Gas' derivative instruments at December 31, 2009, are estimated based on various factors including broker quotes, exchange prices, over the counter prices and time value.

TEP, UNS Gas and UNS Electric manage the risk of counterparty default by performing financial credit reviews, setting limits, monitoring exposures, requiring collateral when needed, and using a standardized agreement, which allows for the netting of current period exposures to and from a single counterparty.

See *Item 7A. Quantitative and Qualitative Disclosures about Market Risk, Commodity Price Risk.*

### **Unbilled Revenue — TEP, UNS Gas and UNS Electric**

TEP's, UNS Gas's and UNS Electric's retail revenues include an estimate of MWhs/therms delivered but unbilled at the end of each period. Unbilled revenues are dependent upon a number of factors that require management's judgment including estimates of retail sales and customer usage patterns. The unbilled revenue is estimated by comparing the estimated MWhs/therms delivered to the MWhs/therms billed to TEP, UNS Gas and UNS Electric retail customers. The excess of estimated MWhs/therms delivered over MWhs/therms billed is then allocated to the retail customer classes based on estimated usage by each customer class. TEP, UNS Gas and UNS Electric then record revenue for each customer class based on the various bill rates for each customer class. Due to the seasonal fluctuations of TEP's actual load, the unbilled revenue amount increases during the spring and summer months and decreases during the fall and winter months. The unbilled revenue amount for UNS Gas sales increases during the fall and winter months and decreases during the spring and summer months, whereas, the unbilled revenue amount for UNS Electric sales increases during the spring and summer months and decreases during the fall and winter months.

### **Plant Asset Depreciable Lives — TEP, UNS Gas and UNS Electric**

We calculate depreciation expense based on our estimate of the useful lives of our plant assets. The estimated useful lives, and resulting depreciation rates presently used to calculate depreciation expense for electric generation and distribution assets for TEP, UNS Gas and UNS Electric have been approved by the ACC in prior rate decisions. Depreciation rates for such assets cannot be changed without ACC approval. Depreciation rates for electric transmission assets fall under the jurisdiction of the FERC.

In January 2010, TEP obtained an updated depreciation study which indicated that its transmission assets depreciable lives should be extended. As a result, TEP adopted new transmission depreciation rates effective January 2010 which will have the effect of reducing depreciation expense by approximately \$14 million annually.

### **Deferred Tax Valuation**

Due to the differences between GAAP and income tax laws, many transactions are treated differently for income tax purposes than they are in the financial statements. This difference is accounted for by recording deferred income tax assets and liabilities on our balance sheets. These assets and liabilities are recorded using the income tax rates in effect on the balance sheet date.

Federal and state income tax credits are treated as a reduction to income tax expense in the year the credit arises.

Prior to 1990, we flowed through to ratepayers certain accelerated tax benefits related to utility plant as the benefits were recognized on the income tax return. Income Taxes Recoverable Through Future Rates on the balance sheet reflects the future revenues due us from ratepayers as these tax benefits reverse. See Note 2.

Consolidated income tax liabilities are allocated to subsidiaries based on their taxable income and deductions as reported in the consolidated tax return.

UniSource Energy and TEP record net interest expense associated with uncertain tax positions as Interest Expense in the income statements. No income tax penalties have been accrued.

At December 31, 2009, TEP had no valuation allowance. See *Note 9 of Notes to Consolidated Financial Statements*.

As of December 31, 2009, UniSource Energy's deferred income tax assets include \$8 million related to unregulated investment losses of Millennium. These losses have not been reflected on UniSource Energy's consolidated income tax returns. If UniSource Energy were unable to recognize such losses through its consolidated income tax return in the foreseeable future, UniSource Energy would be required to write off these deferred tax assets.

### **RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

The following recently issued accounting standards are not yet reflected in the UniSource Energy and TEP financial statements:

- The FASB issued authoritative guidance for transfers of financial assets that clarify and change the criteria for a transfer to be accounted for as a sale, change the amount of a recognized gain/loss on a sale when beneficial interests are received by the transferor, and requires extensive disclosures. This standard is effective for interim and annual periods beginning January 1, 2010. To date, we have not participated in any transfers to which this guidance is applicable.
- The FASB issued authoritative guidance for variable interest entities requiring an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity. This standard did not have a material impact on our financial statements on adoption on January 1, 2010.
- The FASB issued authoritative guidance for multiple deliverable revenue arrangements that provides another alternative for determining the selling price of deliverables and eliminates the residual method of allocating consideration. In addition, this pronouncement requires expanded Quantitative and Qualitative disclosures and is effective for revenue arrangements entered into after January 1, 2011. We are evaluating the impact of this pronouncement.
- The FASB issued amendments that require some new disclosures and clarify some existing disclosure requirements about fair value measurements. The amendments are effective for interim and annual reporting periods beginning January 1, 2010, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in level 3 fair value measurements, which are effective for interim and annual reporting periods beginning January 1, 2011. We are evaluating the impact of these new and revised disclosures on our financial statements.

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

This Annual Report on Form 10-K 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 Annual Report on Form 10-K. 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 in the forward-looking statements. 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 Item 1A. Risk Factors, Item 7. Management's Financial Discussion and Analysis, and other parts of this report: 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 the company's 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; and performance of TEP's generating plants.

## **ITEM 7A. — QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

### **Market Risks**

We are exposed to various forms of market risk. Changes in interest rates, returns on marketable securities, and changes in commodity prices may affect our future financial results.

For additional information concerning risk factors, including market risks, see *Safe Harbor for Forward-Looking Statements*, above.

### **Risk Management Committee**

We have a Risk Management Committee responsible for the oversight of commodity price risk and credit risk related to the wholesale energy marketing activities of TEP and the fuel and power procurement activities at TEP, UNS Gas and UNS Electric. Our Risk Management Committee, which meets on a quarterly basis and as needed, consists of officers from the finance, accounting, legal, wholesale marketing, transmission and distribution operations, and generation operations departments of UniSource Energy. To limit TEP, UNS Gas and UNS Electric's exposure to commodity price risk, the Risk Management Committee sets trading and hedging policies and limits, which are reviewed frequently to respond to constantly changing market conditions. To limit TEP, UNS Gas and UNS Electric's exposure to credit risk, the Risk Management Committee reviews counterparty credit exposure as well as credit policies and limits.

### **Interest Rate Risk**

TEP is exposed to interest rate risk resulting from changes in interest rates on certain of its variable rate debt obligations. At December 31, 2009 and December 31, 2008, TEP had \$459 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 rate payable under the indentures for these bonds is 10% on the 2008 Pima B Bonds and 20% on the other \$329 million in IDBs. The average interest rate on TEP's variable rate debt (excluding letter of credit fees) was 0.41% in 2009 and 2.11% in 2008. The average weekly interest rate ranged from 0.25% to 0.79% in 2009 and 0.55% to 8.09% during 2008. The peak average interest rate of 8.09% occurred in September 2008 when the short-term debt markets began to experience significant disruptions following the bankruptcy filing of Lehman Brothers Holdings, Inc. and the deterioration of creditworthiness of other large financial institutions. Although short-term markets were less volatile in 2009, TEP may still be subject to volatility in its tax-exempt variable rate debt. A 100 basis point increase in average interest rates on this debt, over a twelve month period, would result in a decrease in TEP's pre-tax net income of approximately \$5 million.

To reduce its exposure to variable interest rate risk, in August 2009, TEP entered into an interest rate swap that had the effect of converting \$50 million of variable rate industrial revenue bonds to a fixed rate of 2.4% from September 2009 through September 2014. To further reduce its variable interest rate exposure, in January 2010, TEP converted the interest rate on its \$130 million principal amount of 2008 Pima B Bonds from a variable rate to a fixed rate of 5.75% through maturity in 2029.

At December 31, 2009 and 2008, TEP's debt also included variable rate lease debt totaling \$65 million related to its Springerville Common Facilities Leases. The notes underlying the leases mature in June 2017 and January 2020. Interest is payable at six-month LIBOR plus an applicable spread. The applicable spread was 1.625% at December 31, 2009 and 1.5% at December 31, 2008.

In June 2006 and May 2009, TEP entered into interest rate swaps to hedge the floating interest rate risk associated with the Springerville Common Facilities lease debt. The swaps have the effect of fixing the interest rates on the amortizing principal balances as follows:

<b>Outstanding at Dec. 31, 2009</b>	<b>Fixed Rate</b>	<b>LIBOR Spread</b>
\$35 million	5.77%	1.625%
\$23 million	3.18%	1.625%
\$7 million	3.32%	1.625%

To adjust the value of TEP's interest rate swaps, classified as a cash flow hedge, to fair value in Other Comprehensive Income, TEP recorded the following net unrealized gains (losses):

	<u>2009</u>	<u>2008</u>	<u>2007</u>
		- In Millions-	
Unrealized Gains (Losses)	\$ 1	\$ (5)	\$ (1)

UniSource Energy, TEP, UNS Gas and UNS Electric are also subject to interest rate risk resulting from changes in interest rates on their borrowings under revolving credit facilities. Revolving credit borrowings may be made on the basis of a spread over LIBOR or an Alternate Base Rate. With the recent disruptions in the financial markets, the spread between LIBOR and other similar maturity short-term rates, such as U.S. Treasury securities, has been significantly higher than historical relationships. As a result, UniSource Energy, TEP, UNS Gas and UNS Electric may experience significant volatility in the rates paid on LIBOR borrowings under their revolving credit facilities.

### Marketable Securities Risk

UniSource Energy has a short-term investment policy which governs the investment of excess cash balances by UniSource Energy and its subsidiaries. We review this policy periodically in response to market conditions to adjust, if necessary, the maturities and concentrations by investment type and issuer in the investment portfolio. As of December 31, 2009, UniSource Energy's short-term investments consisted of highly-rated and liquid money market funds, commercial paper, and certificates of deposit. These short-term investments are classified as Cash and Cash Equivalents on the Balance Sheet.

At December 31, 2009 and 2008, TEP had marketable securities comprised of investments in lease debt and equity with an estimated fair value of \$132 million and \$127 million, respectively. At December 31, 2009 and 2008, the fair value exceeded the carrying value by \$8 million and \$17 million, respectively. These securities represent TEP's investments in lease debt and equity underlying certain of TEP's capital lease obligations. Changes in the fair value of such debt securities do not present a material risk to TEP, as TEP intends to hold these investments to maturity.

## Commodity Price Risk

### TEP

TEP is exposed to commodity price risk primarily relating to changes in the market price of electricity, natural gas, coal and emission allowances. Beginning January 1, 2009, this risk is mitigated through a PPFAC mechanism which fully recovers the actual retail fuel and purchased power costs incurred on a timely basis from TEP's retail customers. The PPFAC mechanism has a forward component and a true-up component. The forward component of the PPFAC rate is based on forecasted fuel and purchased power costs. The true-up component reconciles actual fuel and purchased power costs with the amounts collected in the prior year and any amounts under/over-collected will be collected from/credited to customers. If the actual price of power is higher than the forecasted PPFAC rate, TEP is exposed to the price difference until the subsequent 12-month period when the true-up component is adjusted to allow the recovery of this difference. In 2009, the ACC approved a PPFAC rate of 0.18 cents per kWh, resulting in total fuel and purchased power recovery of approximately 3.08 cents per kWh.

### Purchases and Sales of Energy

To manage its exposure to energy price risk, TEP enters into forward contracts to buy or sell energy at a specified price and future delivery period. Generally, TEP commits to future sales based on expected excess generating capability, forward prices and generation costs, using a diversified market approach to provide a balance between long-term, mid-term and spot energy sales. TEP generally enters into forward purchases during its summer peaking period to ensure it can meet its load and reserve requirements and account for other contracts and resource contingencies. TEP also enters into limited forward purchases and sales to optimize its resource portfolio and take advantage of locational differences in price. These positions are managed on both a volumetric and dollar basis and are closely monitored using risk management policies and procedures overseen by the Risk Management Committee. For example, the risk management policies provide that TEP should not take a short physical position in the third quarter and must have owned generation backing up all physical forward sales positions at the time the sale is made. TEP's risk management policies also restrict entering into forward positions with maturities extending beyond the end of the next calendar year except for approved hedging purposes.

TEP's risk management policies also allow for financial purchases and sales of energy subject to specified risk parameters established and monitored by the Risk Management Committee. These include financial trades in a futures account on an exchange, with the intent of optimizing market opportunities.

The majority of TEP's forward contracts are considered to be "normal purchases and sales" of electric energy and are therefore not accounted for as derivatives. TEP records revenues on its "normal sales" and expenses on its "normal purchases" in the period in which the energy is delivered. From time to time, however, TEP enters into forward contracts that meet the definition of a derivative. When TEP has derivative forward contracts, it marks them to market using actively quoted prices obtained from brokers for power traded over-the-counter at Palo Verde and at other Southwestern U.S. trading hubs. TEP believes that these broker quotations used to calculate the mark-to-market values represent accurate measures of the fair values of TEP's positions because of the short-term nature of TEP's positions, as limited by risk management policies, and the liquidity in the short-term market.

### Natural Gas

TEP is also subject to commodity price risk from changes in the price of natural gas. In addition to energy from its coal-fired facilities, TEP typically uses purchased power, supplemented by generation from its gas-fired units to meet the summer peak demands of its retail customers and to meet local reliability needs. Some of these purchased power contracts are price indexed to natural gas prices. Short-term and spot power purchase prices are also closely correlated to natural gas prices. Due to its increasing seasonal gas and purchased power usage, TEP hedges a portion of its total natural gas exposure from plant fuel, gas-indexed purchase power and spot market purchases with fixed price contracts for a maximum of three years. TEP purchases its remaining gas fuel needs and purchased power in the spot and short-term markets.

As required by fair value accounting rules, for the year ended December 31, 2009, TEP considered the impact of non-performance risk in the measurement of fair value of its derivative assets and derivative liabilities net of collateral posted. The adjustment required for TEP was less than \$0.5 million at December 31, 2009.

To adjust the value of its commodity derivatives to fair value in Regulatory Assets or Regulatory Liabilities, TEP recorded the following net unrealized gains (losses):

	2009	2008	2007
		- In Millions-	
Unrealized Gains (Losses)	\$ 11	\$ (19)	\$ —

The chart below displays the valuation methodologies and maturities of TEP's power and gas derivative contracts.

**Unrealized Gain (Loss) of TEP's  
Hedging and Trading Activities**  
- Millions of Dollars -

Source of Fair Value At Dec. 31, 2009	Maturity 0–6 months	Maturity 6–12 months	Maturity over 1 yr.	Total Unrealized Gain (Loss)
Prices actively quoted	\$ (1)	\$ (3)	\$ (1)	\$ (5)
Prices based on models and other valuation methods	—	—	(4)	(4)
<b>Total</b>	<b>\$ (1)</b>	<b>\$ (3)</b>	<b>\$ (5)</b>	<b>\$ (9)</b>

Sensitivity Analysis of Derivatives

TEP uses sensitivity analysis to measure the impact of favorable and unfavorable changes in market prices on the fair value of its derivative forward contracts. Beginning in December 2008, as a result of the 2008 TEP Rate Order, which permits the recovery of prudent costs associated with hedging contracts through the PPFAC, unrealized gains and losses are recorded as either a regulatory asset or regulatory liability. As contracts settle, the unrealized gains and losses are reversed and realized gains or losses are recorded to the PPFAC. The chart below summarizes the change in unrealized gains or losses if market prices increase or decrease by 10%.

Change in Market Price As of December 31, 2009	- Millions of Dollars -	
	10% Increase	10% Decrease
<b>Non-Cash Flow Hedges</b>		
Forward power sales and purchase contracts	\$ —	\$ —
Gas swap agreements	3	(3)
<b>Cash Flow Hedges</b>		
Forward power sales and purchase contracts	\$ 1	\$ (1)
Gas swap agreements	—	—

Coal

TEP is subject to commodity price risk from changes in the price of coal used to fuel its coal-fired generating plants.

In 2003, TEP amended and extended the long-term coal supply contract for Springerville Units 1 and 2 through 2020 and expects coal reserves to be sufficient to supply the estimated requirements for Units 1 and 2 for their presently estimated remaining lives. During the extension period from 2011 through 2020, the coal price will be determined by the cost of Powder River Basin coal delivered to Springerville Unit 3 subject to a floor and ceiling. Based on current coal market conditions, this range would be from \$24 to \$30 per ton. TEP estimates its future minimum annual payments under this contract to be \$45 million in 2010, the initial contract expiration date, and \$14 million from 2011 through 2020. TEP's coal transportation contract at Springerville runs through June of 2011. TEP estimates minimum annual payments under this contract to be \$13 million in 2010 and \$7 million in 2011.

TEP does not have a long-term coal supply contract from Sundt Unit 4, however it has adequate coal inventory through 2010. Coal burned at Sundt Unit 4 represents less than 10% of TEP's total coal consumption. The long-term rail contract for Sundt Unit 4 is in effect until the earliest of 2015, the remaining life of Sundt Unit 4 or the life of the coal mine. This rail contract requires TEP to transport at least 75,000 tons of coal per year through 2015 at an estimated annual cost of \$2 million or to make a minimum payment of \$1 million.



TEP also participates in jointly-owned generating facilities at Four Corners, Navajo and San Juan, where coal supplies are under long-term contracts administered by the operating agents. TEP expects coal reserves available to these three jointly-owned generating facilities to be sufficient for the remaining lives of the stations.

The contracts to purchase coal for use at the jointly-owned facilities require TEP to purchase minimum amounts of coal at an estimated average annual cost of \$23 million for the next five years. See *Item 7. — Management's Discussion and Analysis of Financial Condition and Results of Operations, UniSource Energy Consolidated, Contractual Obligations and Note 4 of Notes to Consolidated Financial Statements — Commitments and Contingencies, TEP Commitments, Purchase and Transportation Commitments.*

### **UNS Gas**

UNS Gas is subject to commodity price risk, primarily from the changes in the price of natural gas purchased for its customers. This risk is mitigated through the PGA mechanism which provides an adjustment to UNS Gas' retail rates to recover the actual costs of gas and transportation. UNS Gas further reduces this risk by purchasing forward fixed price contracts or entering into financial gas swaps for a portion of its projected gas needs under its Price Stabilization Plan. UNS Gas purchases at least 45% of its estimated gas needs in this manner.

As required by fair value accounting rules, for the year ended December 31, 2009, UNS Gas considered the impact of non-performance risk in the measurement of fair value of its derivative assets and derivative liabilities net of collateral posted. The adjustment required for UNS Gas was less than \$0.5 million at December 31, 2009.

For UNS Gas' forward gas purchase contracts, a 10% decrease in market prices would result in an increase in unrealized net losses reported as a regulatory asset of \$3 million, while a 10% increase in market prices would result in a decrease in unrealized net losses reported as a regulatory asset of \$3 million.

### **UNS Electric**

UNS Electric is exposed to commodity price risk from changes in the price for electricity and natural gas. This risk is mitigated through a PPFAC mechanism which fully recovers the costs incurred on a timely basis. As part of the May 2008 ACC order, a new PPFAC mechanism took effect on June 1, 2008. The PPFAC mechanism has a forward component and a true-up component. The forward component of the PPFAC rate is based on forecasted fuel and purchased power costs. The true-up component reconciles actual fuel and purchased power costs with the amounts collected in the prior year and any amounts under/over-collected will be collected from/credited to customers. If the actual price of power is higher than the forecasted PPFAC rate, UNS Electric is exposed to the price difference until the subsequent 12-month period when the true-up component is adjusted to allow the recovery of this difference. The ACC approved a PPFAC rate of 1.73 cents per kWh, resulting in total fuel and purchased power recovery of approximately 8.7 cents per kWh, an increase of approximately 1.7 cents per kWh in UNS Electric's average retail rate.

UNS Electric enters into various power supply agreements for periods of one to five years. Certain of these contracts are at a fixed price per MW and others are indexed to natural gas prices. UNS Electric estimates its future minimum payments under these contracts to be \$67 million in 2010, \$23 million in 2011, \$14 million in 2012, and \$47 million in 2013, based on natural gas prices at the date of the contracts.

Because a portion of the costs under these contracts will vary from period to period based on the market price of gas, the PPFAC, as currently structured, may not provide recovery of the costs incurred under these new contracts on a timely basis.

For UNS Electric's forward power sales and purchase contracts, a 10% decrease in market prices would result in an increase in unrealized net losses reported as a regulatory asset of \$11 million, while a 10% increase in market prices would result in a decrease in unrealized net losses reported as a regulatory asset of \$11 million.

UNS Electric hedges a portion of its natural gas exposure from gas-indexed purchase power agreements with fixed price contracts. In addition, UNS Electric hedges a portion of its anticipated natural gas exposure from plant fuel. UNS Electric currently has approximately 53% of this aggregate summer exposure hedged for the summer of 2010. UNS Electric will obtain its remaining gas and purchased power needs through a combination of additional forward purchases and purchases in the short-term and spot markets.

As required by fair value accounting rules, for the year ended December 31, 2009, UNS Electric considered the impact of non-performance risk in the measurement of fair value of its derivative assets and derivative liabilities net of collateral posted. The adjustment required for UNS Electric was less than \$0.5 million at December 31, 2009.

For UNS Electric's forward gas purchase contracts, a 10% decrease in market prices would result in an increase in unrealized net losses reported as a regulatory asset of \$1 million, while a 10% increase in market prices would result in a decrease in unrealized net losses reported as a regulatory asset of \$1 million.

### Credit Risk

UniSource Energy is exposed to credit risk in its energy-related marketing and trading activities related to potential nonperformance by counterparties. We manage the risk of counterparty default by performing financial credit reviews, setting limits, monitoring exposures, requiring collateral when needed, and using standard agreements which allow for the netting of current period exposures to and from a single counterparty. We calculate counterparty credit exposure by adding any outstanding receivable (net of amounts payable if a netting agreement exists) to the mark-to-market value of any forward contracts. A positive number means that we are exposed to the creditworthiness of our counterparties. If exposure exceeds credit limits or contractual collateral thresholds, we may request that a counterparty provide credit enhancement in the form of cash collateral or a letter of credit. Conversely, a negative exposure means that a counterparty is exposed to the creditworthiness of TEP, UNS Gas or UNS Electric. If such exposure exceeds credit limits or collateral thresholds, we may be required to post collateral in the form of cash or letters of credit.

During the last three years, financial institution counterparties have become active participants in the wholesale energy markets. TEP, UNS Electric and UNS Gas have each entered into short-term and long-term transactions with several financial institution counterparties with terms of one month through five years. Due to the recent turmoil in the financial and credit markets, we have been closely monitoring our transactions with financial institutions. As of December 31, 2009, the combined credit exposure to TEP, UNS Electric and UNS Gas from financial institution counterparties was less than \$1 million.

As of December 31, 2009, TEP's total credit exposure related to its wholesale marketing and gas hedging activities was approximately \$20 million, including \$7 million of inter-company exposure to UNS Electric. TEP had 2 non-investment grade counterparties with exposure of greater than 10% of its total credit exposure, totaling approximately \$6 million. TEP's total exposure to non-investment grade counterparties was \$7 million.

TEP maintains a margin account with a broker to support certain risk management and trading activities. At December 31, 2009, TEP had less than \$1 million in that margin account. At December 31, 2009, TEP had \$1 million in credit enhancements posted with counterparties, and did not hold any collateral from its counterparties.

UNS Gas is subject to credit risk from non-performance by its supply and hedging counterparties to the extent that these contracts have a mark-to-market value in favor of UNS Gas. As of December 31, 2009, UNS Gas had purchased under fixed price contracts approximately 35% of its expected consumption for the 2010/2011 winter season. At December 31, 2009, UNS Gas had no mark-to-market credit exposure under its supply and hedging contracts. As of December 31, 2009, UNS Gas had posted \$2 million in cash collateral and no letters of credit as credit enhancements with its counterparties, and did not hold any collateral from counterparties.

UNS Electric enters into energy purchase agreements as well as gas hedging contracts to hedge the risk in its gas-indexed power purchase agreements. To the extent that such contracts have a positive mark-to-market value, UNS Electric is exposed to credit risk under those contracts. At December 31, 2009, UNS Electric had no credit exposure under such contracts. As of December 31, 2009, UNS Electric had posted \$11 million in letters of credit and no cash collateral as credit enhancements with its counterparties and had not collected any collateral margin from its counterparties.