

**ITEM 8. — CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA****UniSource Energy — Management's Report on Internal Controls Over Financial Reporting**

UniSource Energy Corporation's management is responsible for establishing and maintaining adequate internal control over financial reporting. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of the UniSource Energy Corporation's internal control over financial reporting as of December 31, 2009. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control — Integrated Framework.

Based on management's assessment using those criteria, management has concluded that, as of December 31, 2009, UniSource Energy Corporation's internal control over financial reporting was effective.

**Tucson Electric Power Company — Management's Report on Internal Controls Over Financial Reporting**

Tucson Electric Power Company's management is responsible for establishing and maintaining adequate internal control over financial reporting. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of Tucson Electric Power Company's internal control over financial reporting as of December 31, 2009. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control — Integrated Framework.

Based on management's assessment using those criteria, management has concluded that, as of December 31, 2009, Tucson Electric Power Company's internal control over financial reporting was effective.

This annual report does not include an attestation report of Tucson Electric Power Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by Tucson Electric Power Company's registered public accounting firm pursuant to temporary rules of the SEC that permit Tucson Electric Power Company to provide only management's report in this annual report.

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders of  
UniSource Energy Corporation:

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of UniSource Energy Corporation and its subsidiaries at December 31, 2009 and December 31, 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Controls Over Financial Reporting. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As described in Note 9 to the consolidated financial statements, the Company changed the manner in which it accounts for uncertain tax positions as of January 1, 2007.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP  
PricewaterhouseCoopers LLP  
Phoenix, Arizona  
February 25, 2010

**Report of Independent Registered Public Accounting Firm**

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

In our opinion, the accompanying consolidated financial statements listed in the index appearing under Item 15(a)(1), present fairly, in all material respects, the financial position of Tucson Electric Power Company and its subsidiaries at December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 9 to the consolidated financial statements, the Company changed the manner in which it accounts for uncertain tax positions as of January 1, 2007.

/s/ PricewaterhouseCoopers LLP  
PricewaterhouseCoopers LLP  
Phoenix, Arizona  
February 25, 2010

**UNISOURCE ENERGY CORPORATION**  
**CONSOLIDATED STATEMENTS OF INCOME**

	Years Ended December 31,		
	<u>2009</u>	<u>2008</u>	<u>2007</u>
	- Thousands of Dollars - (Except Per Share Amounts)		
<b>Operating Revenues</b>			
Electric Retail Sales	<b>\$ 1,047,619</b>	\$ 988,612	\$ 983,993
Provision for Rate Refunds — CTC Revenue	<u>—</u>	<u>(58,092)</u>	<u>—</u>
Net Electric Retail Sales	<b>1,047,619</b>	930,520	983,993
Electric Wholesale Sales	<b>128,627</b>	236,300	196,233
California Power Exchange (CPX) Provision for Wholesale Refunds	<b>(4,172)</b>	—	—
Gas Revenue	<b>144,609</b>	163,977	148,598
Other Revenues	<b>77,741</b>	66,714	52,549
<b>Total Operating Revenues</b>	<b><u>1,394,424</u></b>	<b><u>1,397,511</u></b>	<b><u>1,381,373</u></b>
<b>Operating Expenses</b>			
Fuel	<b>298,655</b>	299,987	297,037
Purchased Energy	<b>294,584</b>	442,210	347,377
Transmission	<b>10,181</b>	19,214	15,648
Increase (Decrease) to Reflect PPFAC/PGA Recovery Treatment	<b>(17,091)</b>	(10,975)	5,259
<b>Total Fuel and Purchased Energy</b>	<b>586,329</b>	750,436	665,321
Other Operations and Maintenance	<b>333,887</b>	295,658	242,264
Depreciation and Amortization	<b>176,018</b>	147,690	140,638
Amortization of Transition Recovery Asset	<b>—</b>	23,945	77,681
Taxes Other Than Income Taxes	<b>45,857</b>	39,339	47,836
<b>Total Operating Expenses</b>	<b><u>1,142,091</u></b>	<b><u>1,257,068</u></b>	<b><u>1,173,740</u></b>
<b>Operating Income</b>	<b><u>252,333</u></b>	<b><u>140,443</u></b>	<b><u>207,633</u></b>
<b>Other Income (Deductions)</b>			
Interest Income	<b>12,072</b>	11,011	18,828
Other Income	<b>18,063</b>	7,838	7,622
Other Expense	<b>(5,292)</b>	(9,286)	(4,380)
<b>Total Other Income (Deductions)</b>	<b><u>24,843</u></b>	<b><u>9,563</u></b>	<b><u>22,070</u></b>
<b>Interest Expense</b>			
Long-Term Debt	<b>58,134</b>	70,227	73,095
Capital Leases	<b>49,270</b>	52,511	59,227
Other Interest Expense	<b>3,468</b>	1,837	5,480
Interest Capitalized	<b>(2,302)</b>	(5,565)	(5,551)
<b>Total Interest Expense</b>	<b><u>108,570</u></b>	<b><u>119,010</u></b>	<b><u>132,251</u></b>
<b>Income Before Income Taxes</b>	<b>168,606</b>	30,996	97,452
Income Tax Expense	<b>64,348</b>	16,975	39,079
<b>Net Income</b>	<b><u>\$ 104,258</u></b>	<b><u>\$ 14,021</u></b>	<b><u>\$ 58,373</u></b>
<b>Weighted-Average Shares of Common Stock Outstanding (000)</b>	<b><u>35,858</u></b>	<b><u>35,632</u></b>	<b><u>35,486</u></b>
<b>Basic Earnings per Share</b>	<b><u>\$ 2.91</u></b>	<b><u>\$ 0.39</u></b>	<b><u>\$ 1.64</u></b>
<b>Diluted Earnings per Share</b>	<b><u>\$ 2.69</u></b>	<b><u>\$ 0.39</u></b>	<b><u>\$ 1.57</u></b>
<b>Dividends Declared per Share</b>	<b><u>\$ 1.16</u></b>	<b><u>\$ 0.96</u></b>	<b><u>\$ 0.90</u></b>

See Notes to Consolidated Financial Statements.



**UNISOURCE ENERGY CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Years Ended December 31,		
	<u>2009</u>	<u>2008</u>	<u>2007</u>
	- Thousands of Dollars -		
<b>Cash Flows from Operating Activities</b>			
Cash Receipts from Electric Retail Sales	\$ 1,145,051	\$ 1,079,964	\$ 1,061,994
Cash Receipts from Electric Wholesale Sales	175,679	353,618	301,616
Cash Receipts from Gas Sales	163,441	182,271	165,678
Cash Receipts from Operating Springerville Unit 3	49,386	53,495	38,887
Cash Receipts from Operating Springerville Unit 4	19,565	4,162	—
Interest Received	13,470	17,246	19,197
Performance Deposits Received	34,630	34,404	12,549
Income Tax Refunds Received	20,242	22,355	1,016
Other Cash Receipts	15,441	15,137	14,603
Sale of Excess Emission Allowances	24	1,494	14,861
Refund of Disputed Transmission Costs	—	10,665	—
Purchased Energy Costs Paid	(334,481)	(577,588)	(450,197)
Fuel Costs Paid	(300,810)	(292,646)	(283,439)
Payment of Other Operations and Maintenance Costs	(236,184)	(196,860)	(158,057)
Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized	(161,574)	(154,548)	(151,074)
Wages Paid, Net of Amounts Capitalized	(122,245)	(108,504)	(106,097)
Interest Paid, Net of Amounts Capitalized	(54,641)	(58,774)	(68,446)
Performance Deposits Paid	(22,260)	(48,520)	(7,900)
Capital Lease Interest Paid	(38,598)	(43,828)	(54,315)
Income Taxes Paid	(9,050)	(9,900)	(20,923)
Excess Tax Benefit from Stock Options Exercised	(3,256)	(633)	(541)
Other Cash Payments	(6,520)	(5,999)	(6,646)
<b>Net Cash Flows — Operating Activities</b>	<u>347,310</u>	<u>277,011</u>	<u>322,766</u>
<b>Cash Flows from Investing Activities</b>			
Capital Expenditures	(287,104)	(357,324)	(245,366)
Payments for Investment in Springerville Lease Debt	(31,375)	—	—
Prepayment Deposit on UED Short-Term Debt	(3,625)	—	—
Deposit — Collateral Trust Bond Trustee	—	(133,111)	—
Proceeds from Investment in Springerville Lease Debt	12,736	24,918	27,732
Other Proceeds from Investing Activities	331	5,137	4,475
Return of Investment from Millennium Energy Businesses	8,333	839	12
Insurance Proceeds for Replacement Assets	4,928	8,035	—
Investment in and Loans to Equity Investees	(207)	(600)	(845)
Other Payments for Investing Activities	(661)	(711)	(3,413)
<b>Net Cash Flows — Investing Activities</b>	<u>(296,644)</u>	<u>(452,817)</u>	<u>(217,405)</u>
<b>Cash Flows from Financing Activities</b>			
Proceeds from Borrowings Under Revolving Credit Facilities	203,000	242,000	205,000
Proceeds from Issuance of Short-Term Debt	30,000	—	—
Proceeds from Stock Options Exercised	3,441	1,969	1,980
Excess Tax Benefit from Stock Options Exercised	3,256	633	541
Other Cash Receipts	5,681	6,028	8,210
Proceeds from Issuance of Long-Term Debt	—	320,745	—
Repayments of Borrowings Under Revolving Credit Facilities	(198,000)	(237,000)	(218,000)
Payments of Capital Lease Obligations	(24,192)	(74,316)	(71,549)
Common Stock Dividends Paid	(41,429)	(34,043)	(31,784)
Repayment of Long-Term Debt	(6,000)	(76,000)	(6,000)
Payment of Debt Issue/Retirement Costs	(2,268)	(3,739)	(465)
Other Cash Payments	(2,405)	(5,672)	(7,162)
<b>Net Cash Flows — Financing Activities</b>	<u>(28,916)</u>	<u>140,605</u>	<u>(119,229)</u>
<b>Net Increase(Decrease) in Cash and Cash Equivalents</b>	<u>21,750</u>	<u>(35,201)</u>	<u>(13,868)</u>
<b>Cash and Cash Equivalents, Beginning of Year</b>	<u>55,172</u>	<u>90,373</u>	<u>104,241</u>

<b>Cash and Cash Equivalents, End of Year</b>	<b>\$ 76,922</b>	<b>\$ 90,373</b>	<b>\$ 90,373</b>
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**Non-Cash Financing Activity**

Repayment of UED Short-Term Debt	\$ (3,625)	\$ —	\$ —
Repayment of Collateral Trust Bonds	\$ —	\$ (128,300)	\$ —

See Note 17 for supplemental cash flow information.

See Notes to Consolidated Financial Statements.

**UNISOURCE ENERGY CORPORATION  
CONSOLIDATED BALANCE SHEETS**

	December 31,	
	<u>2009</u>	<u>2008</u>
	- Thousands of Dollars -	
<b>ASSETS</b>		
<b>Utility Plant</b>		
Plant in Service	\$ 4,147,268	\$ 3,870,493
Utility Plant Under Capital Leases	720,628	702,337
Construction Work in Progress	144,551	171,996
<b>Total Utility Plant</b>	<b>5,012,447</b>	4,744,826
Less Accumulated Depreciation and Amortization	(1,652,296)	(1,580,308)
Less Accumulated Amortization of Capital Lease Assets	(574,437)	(546,825)
<b>Total Utility Plant — Net</b>	<b>2,785,714</b>	2,617,693
<b>Investments and Other Property</b>		
Investments in Lease Debt and Equity	132,168	126,672
Other	60,239	64,096
<b>Total Investments and Other Property</b>	<b>192,407</b>	190,768
<b>Current Assets</b>		
Cash and Cash Equivalents	76,922	55,172
Accounts Receivable — Retail and Other	64,230	74,288
Accounts Receivable — Wholesale Sales	18,288	44,725
Unbilled Accounts Receivable	53,361	60,146
Allowance for Doubtful Accounts	(5,977)	(19,684)
Materials and Fuel Inventory	116,791	92,170
Prepayments	6,759	7,893
Derivative Instruments	2,653	3,437
Regulatory Assets — Derivative Instruments	17,841	38,276
Regulatory Assets — Other	23,931	23,299
Deferred Income Taxes — Current	52,355	61,398
Income Tax Receivable	620	12,720
Interest Receivable on Capital Lease Debt Investment	5,081	4,491
Collateral Posted	1,750	14,120
Other	11,700	9,635
<b>Total Current Assets</b>	<b>446,305</b>	482,086
<b>Regulatory and Other Assets</b>		
Income Taxes Recoverable Through Future Revenues	18,144	19,814
Regulatory Assets — Pension and Other Postretirement Benefits	84,149	112,035
Regulatory Assets — Derivative Instruments	9,503	18,324
Regulatory Assets — Other	35,529	39,395
Derivative Instruments	4,498	3,113
Other Assets	24,993	26,339
<b>Total Regulatory and Other Assets</b>	<b>176,816</b>	219,020
<b>Total Assets</b>	<b>\$ 3,601,242</b>	<b>\$ 3,509,567</b>

See Notes to Consolidated Financial Statements.

**(Consolidated Balance Sheets Continued)**

**UNISOURCE ENERGY CORPORATION  
CONSOLIDATED BALANCE SHEETS**

	December 31,	
	<u>2009</u>	<u>2008</u>
	- Thousands of Dollars -	
<b>CAPITALIZATION AND OTHER LIABILITIES</b>		
<b>Capitalization</b>		
Common Stock Equity	\$ 750,865	\$ 679,274
Capital Lease Obligations	488,349	513,517
Long-Term Debt	1,307,795	1,313,615
<b>Total Capitalization</b>	<u>2,547,009</u>	<u>2,506,406</u>
<b>Current Liabilities</b>		
Current Obligations Under Capital Leases	40,441	18,334
Short-Term Borrowings	35,000	10,000
Current Maturities of Long-Term Debt	12,195	6,000
Accounts Payable	54,152	62,514
Accounts Payable — Purchased Power	44,838	49,146
Interest Accrued	41,396	43,440
Accrued Taxes Other than Income Taxes	36,698	36,746
Accrued Employee Expenses	27,545	26,859
Customer Deposits	25,978	22,656
Regulatory Liabilities — Over-Recovered Purchased Energy Costs	24,258	25,665
Regulatory Liabilities — Other	17,971	8,161
Derivative Instruments	21,186	41,076
Other	3,960	1,460
<b>Total Current Liabilities</b>	<u>385,618</u>	<u>352,057</u>
<b>Deferred Credits and Other Liabilities</b>		
Deferred Income Taxes — Noncurrent	227,199	178,089
Regulatory Liabilities — Net Cost of Removal for Interim Retirements	195,177	151,796
Regulatory Liabilities — Over-Recovered Purchased Energy Costs	16,714	44,469
Derivative Instruments	19,489	29,849
Pension and Other Postretirement Benefits	123,476	157,769
Customer Advances for Construction	31,803	31,062
Other	54,757	58,070
<b>Total Deferred Credits and Other Liabilities</b>	<u>668,615</u>	<u>651,104</u>
<b>Commitments and Contingencies (Note 4)</b>		
<b>Total Capitalization and Other Liabilities</b>	<u>\$ 3,601,242</u>	<u>\$ 3,509,567</u>

See Notes to Consolidated Financial Statements.

**(Consolidated Balance Sheets Concluded)**

**UNISOURCE ENERGY CORPORATION**  
**CONSOLIDATED STATEMENTS OF CAPITALIZATION**

	December 31,			
	<u>2009</u>	<u>2008</u>		
	- Thousands of Dollars -			
<b>COMMON STOCK EQUITY</b>				
Common Stock-No Par Value			<b>\$ 696,206</b>	\$ 687,360
	<u>2009</u>	<u>2008</u>		
Shares Authorized	75,000,000	75,000,000		
Shares Outstanding	35,851,185	35,457,780		
Accumulated Earnings (Deficit)			<b>60,461</b>	(1,231)
Accumulated Other Comprehensive Loss			<b>(5,802)</b>	(6,855)
<b>Total Common Stock Equity</b>			<b><u>750,865</u></b>	<u>679,274</u>
<b>PREFERRED STOCK</b>				
No Par Value, 1,000,000 Shares Authorized, None Outstanding			—	—
<b>CAPITAL LEASE OBLIGATIONS</b>				
Springerville Unit 1			<b>320,843</b>	306,553
Springerville Coal Handling Facilities			<b>85,224</b>	90,812
Springerville Common Facilities			<b>109,499</b>	108,516
Sundt Unit 4			<b>13,077</b>	25,400
Other			<b>147</b>	570
Total Capital Lease Obligations			<b>528,790</b>	531,851
Less Current Maturities			<b>(40,441)</b>	(18,334)
<b>Total Long-Term Capital Lease Obligations</b>			<b><u>488,349</u></b>	<u>513,517</u>
<b>LONG-TERM DEBT</b>				
<b>Issue</b>	<b>Maturity</b>	<b>Interest Rate</b>		
UniSource Energy:				
Convertible Senior Notes	2035	4.50%	<b>150,000</b>	150,000
Credit Agreement	2011	Variable	<b>40,000</b>	58,000
Tucson Electric Power Company:				
Variable Rate IDBs	2011	Variable	<b>458,600</b>	458,600
Unsecured IDBs	2020 – 2033	4.95% to 7.13%	<b>445,015</b>	445,015
UNS Gas and UNS Electric:				
Senior Unsecured Notes	2011 – 2023	6.23% to 7.1%	<b>200,000</b>	200,000
Credit Agreement	2011	Variable	—	8,000
UED:				
Secured Term Loan	2010	Variable	<b>26,375</b>	—
Total Stated Principal Amount			<b>1,319,990</b>	1,319,615
Less Current Maturities			<b>(12,195)</b>	(6,000)
<b>Total Long-Term Debt</b>			<b><u>1,307,795</u></b>	<u>1,313,615</u>
<b>Total Capitalization</b>			<b><u>\$2,547,009</u></b>	<u>\$2,506,406</u>

See Notes to Consolidated Financial Statements.

**UNISOURCE ENERGY CORPORATION**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY AND COMPREHENSIVE**  
**INCOME**

	Common Shares Outstanding*	Common Stock	Accumulated Earnings (Deficit)	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
<b>Balances at December 31, 2006</b>	<b>35,190</b>	<b>\$ 697,426</b>	<b>\$ (27,913)</b>	<b>\$ (15,364)</b>	<b>\$ 654,149</b>
Implementation of FIN 48			696		696
Comprehensive Income:					
2007 Net Income			58,373		58,373
Decrease in Pension and Other Post-Retirement Benefit Liabilities (net of \$3,929 income taxes)				5,993	5,993
Unrealized Loss on Cash Flow Hedges (net of \$2,500 income taxes)				(3,813)	(3,813)
Reclassification of Unrealized Losses on Cash Flow Hedges to Net Income (net of \$996 income taxes)				1,519	1,519
Total Comprehensive Income					62,072
Dividends	—	—	(31,784)		(31,784)
Shares Issued under Stock Compensation Plans	125	1,980			1,980
Tax Benefit Realized from Stock-Based Compensation Plans	—	540			540
Other	—	2,422			2,422
<b>Balances at December 31, 2007</b>	<b>35,315</b>	<b>702,368</b>	<b>(628)</b>	<b>(11,665)</b>	<b>690,075</b>
Impact of Change in Pension Plan Measurement Date			(603)		(603)
Comprehensive Income (Loss):					
2008 Net Income			14,021		14,021
Unrealized Loss on Interest Rate Swap (net of \$2,181 income taxes)				(3,326)	(3,326)
Reclassification of Unrealized Gain on Cash Flow Hedges to Regulatory Asset (net of \$1,370 income taxes)				(2,089)	(2,089)
Reclassification of Unrealized Loss on Cash Flow Hedges to Net Income (net of \$1,569 income taxes)				2,393	2,393
Employee Benefit Obligations					
Amortization of net actuarial loss and prior service credit included in net periodic benefit cost (net of \$158 income taxes)				(242)	(242)
Increase in SERP Liability (net of \$108 income taxes)				(165)	(165)
Reclassification of Pension and Other Postretirement Benefit to Regulatory Asset (net of \$5,401 income taxes)				8,239	8,239
Total Comprehensive Income					18,831
Dividends	—	(20,017)	(14,021)	—	(34,038)
Shares Issued under Stock Compensation Plans	143	1,969	—	—	1,969
Tax Benefit Realized from Stock-Based Compensation Plans	—	633	—	—	633
Other	—	2,407	—	—	2,407
<b>Balances at December 31, 2008</b>	<b>35,458</b>	<b>687,360</b>	<b>(1,231)</b>	<b>(6,855)</b>	<b>679,274</b>
Comprehensive Income:					
2009 Net Income			104,258		104,258
Unrealized Loss on Cash Flow Hedges (net of \$33 income taxes)				51	51
Reclassification of Unrealized Losses on Cash Flow					

Hedges to Net Income (net of \$690 income taxes)					
Employee Benefit Obligations					
Amortization of SERP Net Prior Service Cost					
Included in Net Periodic Benefit Cost (net of \$33 income taxes)				(51)	(51)
Total Comprehensive Income					105,311
Dividends			(42,566)		(42,566)
Shares Issued under Deferred Compensation Plans	10	279			279
Shares Issued under Stock Compensation Plans — (net of shares redeemed for taxes)	383	2,541			2,541
Tax Benefit Realized from Stock-Based Compensation Plans		3,256			3,256
Other Stock-Based Compensation		2,770			2,770
<b>Balances at December 31, 2009</b>	<u>35,851</u>	<u>\$ 696,206</u>	<u>\$ 60,461</u>	<u>\$ (5,802)</u>	<u>\$ 750,865</u>

\* UniSource Energy has 75 million authorized shares of Common Stock.

We describe limitations on our ability to pay dividends in Note 8.

See Notes to Consolidated Financial Statements.

**TUCSON ELECTRIC POWER COMPANY  
CONSOLIDATED STATEMENTS OF INCOME**

	Years Ended December 31,		
	2009	2008	2007
	- Thousands of Dollars -		
<b>Operating Revenues</b>			
Electric Retail Sales	\$ 867,516	\$ 805,528	\$ 816,471
Provision for Rate Refunds — CTC Revenue	—	(58,092)	—
Net Electric Retail Sales	867,516	747,436	816,471
Electric Wholesale Sales	150,679	259,855	195,999
California Power Exchange (CPX) Provision for Wholesale Refunds	(4,172)	—	—
Other Revenues	82,688	71,962	58,033
<b>Total Operating Revenues</b>	<b>1,096,711</b>	<b>1,079,253</b>	<b>1,070,503</b>
<b>Operating Expenses</b>			
Fuel	281,710	289,985	296,511
Purchased Power	142,252	238,024	140,498
Transmission	3,066	10,515	9,014
Increase (Decrease) to Reflect PPFAC Recovery Treatment	(20,724)	—	—
<b>Total Fuel and Purchased Energy</b>	<b>406,304</b>	<b>538,524</b>	<b>446,023</b>
Other Operations and Maintenance	289,765	256,584	202,837
Depreciation and Amortization	152,901	126,040	119,811
Amortization of Transition Recovery Asset	—	23,945	77,681
Taxes Other Than Income Taxes	37,618	31,650	40,366
<b>Total Operating Expenses</b>	<b>886,588</b>	<b>976,743</b>	<b>886,718</b>
<b>Operating Income</b>	<b>210,123</b>	<b>102,510</b>	<b>183,785</b>
<b>Other Income (Deductions)</b>			
Interest Income	11,471	9,900	16,073
Other Income	10,991	5,708	3,665
Other Expense	(2,904)	(6,249)	(3,296)
<b>Total Other Income (Deductions)</b>	<b>19,558</b>	<b>9,359</b>	<b>16,442</b>
<b>Interest Expense</b>			
Long-Term Debt	36,226	47,456	50,230
Interest on Capital Leases	49,258	52,491	59,205
Other Interest Expense	1,571	1,367	4,538
Interest Capitalized	(1,752)	(4,675)	(2,744)
<b>Total Interest Expense</b>	<b>85,303</b>	<b>96,639</b>	<b>111,229</b>
<b>Income Before Income Taxes</b>	<b>144,378</b>	<b>15,230</b>	<b>88,998</b>
Income Tax Expense	55,130	10,867	35,542
<b>Net Income</b>	<b>\$ 89,248</b>	<b>\$ 4,363</b>	<b>\$ 53,456</b>

See Notes to Consolidated Financial Statements.

**TUCSON ELECTRIC POWER COMPANY  
CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Years Ended December 31,		
	<u>2009</u>	<u>2008</u>	<u>2007</u>
	- Thousands of Dollars -		
<b>Cash Flows from Operating Activities</b>			
Cash Receipts from Electric Retail Sales	\$ 944,873	\$ 883,423	\$ 883,885
Cash Receipts from Electric Wholesale Sales	199,918	377,579	301,616
Cash Receipts from Operating Springerville Unit 3	49,386	53,495	38,887
Cash Receipts from Operating Springerville Unit 4	19,565	4,162	—
Interest Received	12,768	15,849	16,284
Income Tax Refunds Received	14,462	20,902	—
Reimbursement of Affiliate Charges	19,998	16,534	—
Refund of Disputed Transmission Costs	—	10,665	—
Performance Deposits Received	14,000	10,150	—
Sale of Excess Emission Allowances	24	1,494	16,975
Other Cash Receipts	10,101	7,774	7,931
Fuel Costs Paid	(282,653)	(284,830)	(283,440)
Purchased Power Costs Paid	(185,129)	(364,356)	(245,439)
Payment of Other Operations and Maintenance Costs	(223,760)	(185,206)	(144,753)
Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized	(124,053)	(117,611)	(116,641)
Wages Paid, Net of Amounts Capitalized	(97,289)	(84,857)	(82,661)
Capital Lease Interest Paid	(38,586)	(43,807)	(54,293)
Interest Paid, Net of Amounts Capitalized	(33,128)	(38,467)	(47,050)
Income Taxes Paid	(14,606)	—	(23,609)
Performance Deposits Paid	(14,000)	(10,150)	—
Other Cash Payments	(3,827)	(4,037)	(3,580)
<b>Net Cash Flows — Operating Activities</b>	<u>268,064</u>	<u>268,706</u>	<u>264,112</u>
<b>Cash Flows from Investing Activities</b>			
Capital Expenditures	(235,485)	(294,940)	(162,539)
Payments for Investments in Lease Debt and Equity	(31,375)	—	—
Deposit — Collateral Trust Bond Trustee	—	(133,111)	—
Proceeds from Investments in Springerville Lease Debt	12,736	24,918	27,732
Insurance Proceeds for Replacement Assets	4,928	8,035	—
Other Cash Receipts	6	5,055	650
Other Cash Payments	(411)	(711)	(2,968)
<b>Net Cash Flows — Investing Activities</b>	<u>(249,601)</u>	<u>(390,754)</u>	<u>(137,125)</u>
<b>Cash Flows from Financing Activities</b>			
Proceeds from Issuance of Long-Term Debt	—	220,745	—
Proceeds from Borrowings Under Revolving Credit Facility	171,000	170,000	160,000
Repayments of Borrowings Under Revolving Credit Facility	(146,000)	(170,000)	(180,000)
Payments of Capital Lease Obligations	(24,091)	(74,228)	(71,464)
Repayments of Long-Term Debt	—	(10,000)	—
Dividends Paid to UniSource Energy	(60,000)	(2,500)	(53,000)
Equity Investment from UniSource Energy	30,000	—	18,000
Other Cash Receipts	2,447	1,237	7,795
Payment of Debt Issue/Retirement Costs	(1,329)	(3,120)	(451)
Other Cash Payments	(1,347)	(3,421)	(968)
<b>Net Cash Flows — Financing Activities</b>	<u>(29,320)</u>	<u>128,713</u>	<u>(120,088)</u>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>(10,857)</b>	6,665	6,899
<b>Cash and Cash Equivalents, Beginning of Year</b>	<b>33,275</b>	26,610	19,711
<b>Cash and Cash Equivalents, End of Year</b>	<b>\$ 22,418</b>	<b>\$ 33,275</b>	<b>\$ 26,610</b>
<b>Non-Cash Financing Activity — Repayment of Collateral Trust Bonds</b>	<b>\$ —</b>	<b>\$ (128,300)</b>	<b>\$ —</b>

See Note 17 for supplemental cash flow information.



**TUCSON ELECTRIC POWER COMPANY  
CONSOLIDATED BALANCE SHEETS**

	December 31,	
	<u>2009</u>	<u>2008</u>
	- Thousands of Dollars -	
<b>ASSETS</b>		
<b>Utility Plant</b>		
Plant in Service	\$ 3,584,308	\$ 3,351,474
Utility Plant Under Capital Leases	719,922	701,631
Construction Work in Progress	113,390	145,457
<b>Total Utility Plant</b>	<b>4,417,620</b>	<b>4,198,562</b>
Less Accumulated Depreciation and Amortization	(1,582,442)	(1,531,611)
Less Accumulated Amortization of Capital Lease Assets	(573,853)	(546,332)
<b>Total Utility Plant — Net</b>	<b>2,261,325</b>	<b>2,120,619</b>
<b>Investments and Other Property</b>		
Investments in Lease Debt and Equity	132,168	126,672
Other	31,813	31,291
<b>Total Investments and Other Property</b>	<b>163,981</b>	<b>157,963</b>
<b>Current Assets</b>		
Cash and Cash Equivalents	22,418	33,275
Accounts Receivable — Retail and Other	46,894	53,091
Accounts Receivable — Wholesale	17,904	44,610
Unbilled Accounts Receivable	32,368	33,554
Allowance for Doubtful Accounts	(3,806)	(17,135)
Accounts Receivable — Due from Affiliates	5,218	16,614
Materials and Fuel Inventory	104,861	81,067
Prepayments	5,678	5,535
Derivative Instruments	5,043	5,129
Regulatory Assets — Derivative Instruments	3,696	14,242
Regulatory Assets — Other	23,330	22,834
Deferred Income Taxes — Current	50,789	59,615
Interest Receivable on Capital Lease Debt Investment	5,081	4,491
Other	11,313	10,554
<b>Total Current Assets</b>	<b>330,787</b>	<b>367,476</b>
<b>Regulatory and Other Assets</b>		
Regulatory Assets — Pension and Other Postretirement Benefits	80,169	106,596
Regulatory Assets — Derivatives	4,631	5,400
Regulatory Assets — Other	34,203	38,180
Income Taxes Recoverable Through Future Revenues	18,144	19,814
Derivative Instruments	1,075	4,982
Other Assets	19,984	20,741
<b>Total Regulatory and Other Assets</b>	<b>158,206</b>	<b>195,713</b>
<b>Total Assets</b>	<b>\$ 2,914,299</b>	<b>\$ 2,841,771</b>

See Notes to Consolidated Financial Statements.

(Consolidated Balance Sheets Continued)

TUCSON ELECTRIC POWER COMPANY  
CONSOLIDATED BALANCE SHEETS

	December 31,	
	<u>2009</u>	<u>2008</u>
	- Thousands of Dollars -	
<b>CAPITALIZATION AND OTHER LIABILITIES</b>		
<b>Capitalization</b>		
Common Stock Equity	\$ 643,144	\$ 583,606
Capital Lease Obligations	488,311	513,370
Long-Term Debt	903,615	903,615
<b>Total Capitalization</b>	<u>2,035,070</u>	<u>2,000,591</u>
<b>Current Liabilities</b>		
Current Obligations Under Capital Leases	40,332	18,231
Borrowings Under Revolving Credit Facility	35,000	10,000
Accounts Payable	48,631	56,001
Accounts Payable — Purchased Power	22,697	28,510
Accounts Payable — Due from Affiliates	3,694	3,610
Income Taxes Payable	—	2,057
Interest Accrued	33,970	35,828
Accrued Taxes Other than Income Taxes	28,404	27,679
Accrued Employee Expenses	24,409	23,990
Customer Deposits	18,125	15,902
Derivative Instruments	9,434	18,737
Regulatory Liabilities — Over-Recovered Purchased Energy Costs	9,200	14,310
Regulatory Liability — Other	17,439	7,083
Other	1,363	1,204
<b>Total Current Liabilities</b>	<u>292,698</u>	<u>263,142</u>
<b>Deferred Credits and Other Liabilities</b>		
Deferred Income Taxes — Noncurrent	217,316	180,098
Regulatory Liabilities — Net Cost of Removal for Interim Retirements	162,764	122,037
Regulatory Liabilities — Over-Recovered Purchased Energy Costs	16,714	44,469
Derivative Instruments	11,195	18,794
Pension and Other Postretirement Benefits	116,991	149,955
Other	61,551	62,685
<b>Total Deferred Credits and Other Liabilities</b>	<u>586,531</u>	<u>578,038</u>
<b>Commitments and Contingencies (Note 4)</b>		
<b>Total Capitalization and Other Liabilities</b>	<u>\$ 2,914,299</u>	<u>\$ 2,841,771</u>

See Notes to Consolidated Financial Statements.

(Consolidated Balance Sheets Concluded)

**TUCSON ELECTRIC POWER COMPANY  
CONSOLIDATED STATEMENTS OF CAPITALIZATION**

	December 31,			
	<u>2009</u>	<u>2008</u>		
	- Thousands of Dollars -			
<b>COMMON STOCK EQUITY</b>				
Common Stock—No Par Value	<b>\$ 843,971</b>	\$ 813,971		
	<u>2009</u>	<u>2008</u>		
Shares Authorized	<b>75,000,000</b>	75,000,000		
Shares Outstanding	<b>32,139,434</b>	32,139,434		
Capital Stock Expense	<b>(6,357)</b>	(6,357)		
Accumulated Deficit	<b>(188,668)</b>	(217,153)		
Accumulated Other Comprehensive Loss	<b>(5,802)</b>	(6,855)		
<b>Total Common Stock Equity</b>	<b><u>643,144</u></b>	<u>583,606</u>		
<b>PREFERRED STOCK</b>				
No Par Value, 1,000,000 Shares Authorized, None Outstanding	<u>—</u>	<u>—</u>		
<b>CAPITAL LEASE OBLIGATIONS</b>				
Springerville Unit 1	<b>320,843</b>	306,553		
Springerville Coal Handling Facilities	<b>85,224</b>	90,812		
Springerville Common Facilities	<b>109,499</b>	108,516		
Sundt Unit 4	<b>13,077</b>	25,400		
Other Leases	<u>—</u>	320		
Total Capital Lease Obligations	<b>528,643</b>	531,601		
Less Current Maturities	<b>(40,332)</b>	(18,231)		
<b>Total Long-Term Capital Lease Obligations</b>	<b><u>488,311</u></b>	<u>513,370</u>		
<b>LONG-TERM DEBT</b>				
<b>Issue</b>	<b>Maturity</b>	<b>Interest Rate</b>		
Variable Rate IDBs	2011	Variable	<b>458,600</b>	458,600
Unsecured IDBs	2020 – 2033	4.95% to 7.125%	<b>445,015</b>	445,015
<b>Total Long-Term Debt</b>			<b><u>903,615</u></b>	<u>903,615</u>
<b>Total Capitalization</b>			<b><u>\$2,035,070</u></b>	<u>\$2,000,591</u>

See Notes to Consolidated Financial Statements.

**TUCSON ELECTRIC POWER COMPANY**  
**CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDER'S EQUITY AND COMPREHENSIVE INCOME**

	Common Stock	Capital Stock Expense	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Stockholder's Equity
	- Thousands of Dollars -				
<b>Balances at December 31, 2006</b>	<b>\$ 795,971</b>	<b>\$ (6,357)</b>	<b>\$ (219,640)</b>	<b>\$ (15,260)</b>	<b>\$ 554,714</b>
Implementation of FIN 48			696		696
Comprehensive Income:					
2007 Net Income			53,456		53,456
Decrease in Pension and Other Post-Retirement Benefit Liabilities (net of \$3,820 income taxes)				5,826	5,826
Unrealized Loss on Cash Flow Hedges (net of \$2,532 income taxes)				(3,862)	(3,862)
Reclassification of Unrealized Losses on Cash Flow Hedges to Net Income to Regulatory Asset (net of \$996 income taxes)				1,519	1,519
Total Comprehensive Income					56,939
Capital Contribution from UniSource Energy	18,000				18,000
Dividends Paid			(53,000)		(53,000)
<b>Balances at December 31, 2007</b>	<b>813,971</b>	<b>(6,357)</b>	<b>(218,488)</b>	<b>(11,777)</b>	<b>577,349</b>
Impact of Change in Pension Plan Measurement Date			(528)		(528)
Comprehensive Income (Loss):					
2008 Net Income			4,363		4,363
Unrealized Loss on Interest Rate Swap (net of \$2,181 income taxes)				(3,326)	(3,326)
Reclassification of Unrealized Gain on Cash Flow Hedges to Regulatory Asset (net of \$1,337 income taxes)				(2,039)	(2,039)
Reclassification of Unrealized Loss on Cash Flow Hedges to Net Income (net of \$1,569 income taxes)				2,393	2,393
Employee Benefit Obligations					
Amortization of net actuarial loss and prior service credit included in net periodic benefit cost (net of \$157 income taxes)				(240)	(240)
Increase in SERP Liability (net of \$108 income taxes)				(165)	(165)
Reclassification of Pension and Other Postretirement Benefit to Regulatory Asset (net of \$5,441 income taxes)				8,299	8,299
Total Comprehensive Income					9,285
Dividends Paid			(2,500)		(2,500)
<b>Balances at December 31, 2008</b>	<b>813,971</b>	<b>(6,357)</b>	<b>(217,153)</b>	<b>(6,855)</b>	<b>583,606</b>
Comprehensive Income:					
2009 Net Income			89,248		89,248
Unrealized Loss on Cash Flow Hedges (net of \$33 income taxes)				51	51
Reclassification of Unrealized Losses on Cash Flow Hedges to Net Income (net of \$690 income taxes)				1,053	1,053
Employee Benefit Obligations					
Amortization of SERP Net Prior Service Cost Included in Net Periodic Benefit Cost (net of \$33 income taxes)				(51)	(51)
Total Comprehensive Income					90,301
Capital Contribution from UniSource Energy	30,000				30,000

Dividends				<b>(60,763)</b>				
<b>Balances at December 31, 2009</b>	<b><u>\$ 843,971</u></b>	<b><u>\$ (6,357)</u></b>	<b><u>\$ (188,668)</u></b>	<b><u>\$ (5,802)</u></b>	<b><u>\$ 643,144</u></b>			

We describe limitations on our ability to pay dividends in Note 8.

See Notes to Consolidated Financial Statements.

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**UNISOURCE ENERGY, TEP AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — DRAFT****Audit Committee  
2/19/10****NOTE 1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES****NATURE OF OPERATIONS**

UniSource Energy Corporation (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 100% of Tucson Electric Power Company (TEP), UniSource Energy Services, Inc. (UES), Millennium Energy Holdings, Inc. (Millennium) and UniSource Energy Development Company (UED).

TEP, a regulated public utility, is UniSource Energy's largest operating subsidiary and represented approximately 81% of UniSource Energy's assets as of December 31, 2009. TEP generates, transmits and distributes electricity to approximately 402,000 retail electric customers in a 1,155 square mile area in Southern Arizona. TEP also sells electricity to other utilities and power marketing entities primarily located in the Western U.S. In addition, TEP operates Springerville Unit 3 on behalf of Tri-State Generation and Transmission Association, Inc. (Tri-State) and beginning in December 2009 Springerville Unit 4 on behalf of Salt River Project Agriculture Improvement and Power District (SRP).

UES holds the common stock of UNS Gas, Inc. (UNS Gas) and UNS Electric, Inc. (UNS Electric). UNS Gas is a gas distribution company with 146,000 retail customers in Mohave, Yavapai, Coconino, and Navajo counties in Northern Arizona, as well as Santa Cruz County in South Central Arizona. UNS Electric is an electric transmission and distribution company with approximately 90,000 retail customers in Mohave and Santa Cruz counties.

Millennium invests in unregulated businesses. In June 2009, Millennium sold its 50% equity interest in Carboelectrica Sabinas, S. de R.L. de C.V. See Note 15.

Our business is comprised of three reporting segments – TEP, UNS Gas and UNS Electric.

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

**BASIS OF PRESENTATION**

We account for our investments in subsidiaries using the consolidation method when we hold a majority of a subsidiary's voting stock and we can exercise control over the subsidiary. The accounts of the subsidiary and parent are combined, and intercompany balances and transactions are eliminated. Intercompany profits on transactions between regulated entities are not eliminated.

We use the equity method to report corporate joint ventures, partnerships, and affiliated company investments when we can demonstrate the ability to exercise significant influence over the operating and financial policies of an investee company. Equity method investments are recorded at cost and appear on a single line item on the balance sheet and net income (loss) from the entity is reflected in Other Income on the income statements. Quarterly, we review the equity investments and where there is an other-than-temporary impairment, we recognize the loss in earnings.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****USE OF ACCOUNTING ESTIMATES**

We make estimates and assumptions to prepare financial statements under accounting principles generally accepted in the U.S. (GAAP). These estimates and assumptions affect:

- A portion of the reported amounts of assets and liabilities at the dates of the financial statements;
- Our disclosures about contingent assets and liabilities at the dates of the financial statements; and
- A portion of revenues and expenses reported during the periods presented.

Because these estimates involve judgments, the actual amounts may differ from the estimates.

**ACCOUNTING FOR RATE REGULATION**

TEP, UNS Gas and UNS Electric generally use the same accounting policies and practices used by unregulated companies. However, sometimes regulatory accounting requires rate-regulated companies to apply special accounting treatment to show the effect of rate-regulation. For example, the ACC can determine that TEP, UNS Gas or UNS Electric are allowed to recover certain expenses, but at a designated time in the future. In this situation, TEP, UNS Gas and UNS Electric defer these items and show them as regulatory assets on the balance sheet until they are allowed to charge their customers. TEP, UNS Gas and UNS Electric then amortize these items as expenses as they recover these charges 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. We evaluate our regulatory assets each period and believe recovery is probable.

Beginning in December 2008, as a result of the 2008 TEP Rate Order, TEP reapplied regulatory accounting to its generation operations. See Note 2.

The conditions a rate-regulated company must satisfy to apply regulatory accounting policies and practices include:

- An independent regulator sets rates;
- The regulator sets the rates to recover the specific enterprise's costs of providing service; and
- The service territory lacks competitive pressures to reduce rates below the rates set by the regulator.

**CASH AND CASH EQUIVALENTS**

We define Cash and Cash Equivalents as cash (unrestricted demand deposits) and all highly liquid investments purchased with an original maturity of three months or less.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****UTILITY PLANT**

TEP, UNS Gas and UNS Electric report utility plant at cost. Costs included in utility plant are materials and labor, contractor services, construction overhead (where applicable), and an Allowance for Funds Used During Construction (AFUDC).

Costs to replace major units of property are included in utility plant. The cost of planned major maintenance activities, including scheduled overhauls at TEP's generation plants, is recorded as the costs are actually incurred. Replacement of capital equipment included in plant maintenance activities is capitalized to utility plant. TEP, UNS Gas and UNS Electric charge the cost of repairs and minor replacements to Other Operations and Maintenance expense.

When a unit of regulated property is retired, the original cost plus removal costs less any salvage value is credited or charged to accumulated depreciation. Prior to December 2008, before TEP reapplied regulatory accounting to its generation operations, interim retirements of unregulated generation plant, together with the cost of removal less salvage, were charged to accumulated depreciation.

**AFUDC and Capitalized Interest**

AFUDC, which reflects the cost of debt or equity funds used to finance construction, is capitalized as part of the cost of regulated utility plant. AFUDC applies to all regulated operations that follow regulatory accounting. AFUDC amounts capitalized are included in rate base for establishing utility rates. For operations that do not apply regulatory accounting, interest related only to debt is capitalized as a cost of construction. The interest capitalized that relates to debt reduces Other Interest Expense on the income statement. The cost capitalized that relates to equity funds is recorded as Other Income. Beginning in December 2008, when TEP reapplied regulatory accounting to its generation operations, TEP began capitalizing costs that relate to equity funds. See Note 2.

	<b>TEP</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
Average AFUDC rate on regulated construction expenditures	6.4%	7.5%	10.05%
AFUDC — Debt (in millions)	\$ 2	\$ 2	\$ 2
AFUDC — Equity (in millions)	\$ 4	\$ 3	\$ 1
Average capitalized interest rate on generation-related construction expenditures (before December 2008)	N/A	5.02%	5.73%
Capitalized interest (in millions)	N/A	\$ 2	\$ 1

	<b>UNS Gas</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
Average AFUDC rate on regulated construction expenditures	7.05%	8.37%	8.12%
AFUDC — Debt (in millions)	\$ 0.1	\$ 0.1	\$ 0.3
AFUDC — Equity (in millions)	\$ 0.1	\$ 0.1	\$ 0.3

	<b>UNS Electric</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
Average AFUDC rate on regulated construction expenditures	7.62%	8.84%	13.51%
AFUDC — Debt (in millions)	\$ 0.4	\$ 0.2	\$ 0.7
AFUDC — Equity (in millions)	\$ 0.5	\$ 0.3	\$ 0.4

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****Depreciation**

TEP, UNS Gas, UNS Electric and UED compute depreciation for owned utility plant on a group method straight-line basis at rates based on the economic lives of the assets. See Note 5. The ACC approves depreciation rates for all utility plant, except that of UED and the transmission assets of TEP which are subject to FERC jurisdiction. Depreciation rates are based on average useful lives and reflect estimated removal costs, net of estimated salvage value for interim retirements. Prior to December 2008, before TEP reapplied regulatory accounting to its generation operations, the depreciable lives for TEP's generation assets were based on remaining useful lives. We have summarized the average annual depreciation rates for all utility plants below.

<b>Year</b>	<b>TEP</b>	<b>UNS Gas</b>	<b>UNS Electric</b>	<b>UED</b>
2009	3.64%	2.76%	4.33%	2.57%
2008	3.33%	2.77%	4.47%	2.57%
2007	3.35%	3.28%	4.60%	N/A

**Computer Software Costs**

TEP, UNS Gas and UNS Electric capitalize costs incurred to purchase and develop computer software for internal use and amortize those costs over the estimated economic life of the product. If the software is no longer useful, we immediately charge capitalized computer software costs to expense. TEP amortized capitalized computer software costs of \$8 million in 2009, \$7 million in 2008, and \$9 million in 2007.

**TEP Utility Plant under Capital Leases**

TEP financed the following generation assets with capital leases: Springerville Common Facilities, Springerville Unit 1, Springerville Coal Handling Facilities, and Sundt Unit 4. The following table shows the amount of lease expense incurred for TEP's generation-related capital leases. The lease terms are described in TEP Capital Lease Obligations in Note 6.

	Years Ended December 31,		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
	-Millions of Dollars-		
Lease Expense:			
Interest Expense – Included in:			
Interest on Capital Leases	\$ 49	\$ 52	\$ 59
Operating Expenses – Fuel	5	5	5
Amortization of Capital Lease Assets – Included in:			
Operating Expenses – Fuel	2	4	4
Operating Expenses – Depreciation and Amortization	26	21	21
Total Lease Expense	<u>\$ 82</u>	<u>\$ 82</u>	<u>\$ 89</u>

**INVESTMENTS IN LEASE DEBT AND EQUITY**

TEP has investments in lease debt in two of TEP's capital leases: Springerville Unit 1 and Springerville Coal Handling Facilities. TEP's investments in lease debt are considered to be held-to-maturity investments because TEP has the ability and intent to hold until maturity. TEP records these investments at amortized cost and recognizes interest income. See Note 6. These investments do not reduce the capital lease obligations reflected on the balance sheet because there is no legal right of offset. TEP makes lease payments to a trustee who then distributes the payments to debt and equity holders.

TEP accounts for its 14% equity interest in the Springerville Unit 1 lease trust using the equity method.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****JOINTLY-OWNED FACILITIES**

TEP has investments in several plants and transmission facilities jointly owned with other utilities. These projects are accounted for on a proportionate consolidation basis. See Note 5.

**ASSET RETIREMENT OBLIGATIONS**

TEP records a liability for the estimated present value of a conditional asset retirement obligation as follows:

- When it is able to reasonably estimate the fair value of any future obligation to retire as a result of an existing or enacted law, statute, ordinance or contract; or
- If it can reasonably estimate the fair value.

When the liability is initially recorded at net present value, TEP capitalizes the cost by increasing the carrying amount of the related long-lived asset. Over time, TEP adjusts the liability to its present value by recognizing accretion expense each period in other operations and maintenance expense, and the capitalized cost is depreciated in depreciation and amortization expense over the useful life of the related asset. Upon retirement of the asset, TEP either settles the obligation for its recorded amount or incurs a gain or loss if the actual costs differ from the recorded amount.

Beginning in December 2008, when TEP reapplied regulatory accounting to its generation operations, TEP began recording cost of removal for its generation assets that is recoverable through rates charged to customers. See Note 2. TEP, UNS Gas and UNS Electric record cost of removal for their transmission and distribution assets through depreciation rates and recover those amounts in rates charged to their customers. There are no legal obligations associated with these assets. TEP, UNS Gas and UNS Electric have recorded their obligation for estimated costs of removal as regulatory liabilities.

**EVALUATION OF ASSETS FOR IMPAIRMENT**

TEP, UNS Gas and UNS Electric evaluate their Utility Plant and other long-lived assets for impairment whenever events or circumstances indicate that the value of the assets may be impaired. If the fair value of the asset, determined based on the undiscounted expected future cash flows, is less than the carrying value of the asset, an impairment charge would be recorded.

Millennium evaluates its investments for impairment at the end of each quarter. If the decline in fair value is judged to be other-than-temporary, an impairment loss would be recorded.

**DEFERRED FINANCING COSTS**

We defer costs related to the issuance of debt. We amortize on a straight-line basis over the life of the debt as this approximates the effective interest method. These costs include underwriters' commissions, discounts or premiums, and other costs such as legal, accounting and regulatory fees and printing costs.

TEP, UNS Gas and UNS Electric defer and amortize the gains and losses on reacquired debt associated with their regulated operations to interest expense over the remaining life of the original debt. Prior to December 2008, when TEP reapplied regulatory accounting to its generation operations, TEP recognized gains and losses on reacquired debt, including unamortized debt issuance costs, associated with its generation operations, as incurred.

**UTILITY OPERATING REVENUES**

TEP, UNS Gas and UNS Electric record utility operating revenues when services are provided or commodities are delivered to customers. Operating revenues include unbilled revenues which are earned (service has been provided) but not billed by the end of an accounting period.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10**

Amounts delivered are determined through systematic monthly readings of customer meters. At the end of the month, the usage since the last meter reading is estimated and the corresponding unbilled revenue is calculated. Unbilled revenue is estimated based on daily generation or purchased volumes, estimated customer usage by class, estimated line losses and estimated average customer rates. Accrued unbilled revenues are reversed the following month when actual billings occur. The accuracy of the unbilled revenue estimate is affected by factors that include fluctuations in energy demands, weather, line losses, and changes in the composition of customer classes.

Effective in January 2009, as a result of the 2008 TEP Rate Order, TEP has a rate-adjustment mechanism that provides for the recovery of fuel and purchased energy cost. UNS Gas and UNS Electric also have rate-adjustment mechanisms in place that allow for a revenue surcharge or surcredit (that adjusts the customer's base rate for delivered purchased power or gas) to collect or return under- or over- recovery of costs. These rate-adjustment mechanisms are revised periodically and may increase or decrease the level of costs recovered through base rates for any difference between the total amount collected under the clauses and the recoverable costs incurred. See Note 2.

TEP's wholesale revenue and purchased power costs from settled energy contracts that are not physically delivered are reported on a net basis in Electric Wholesale Sales. The corresponding cash receipts and payments are recorded in the statement of cash flows as Cash Receipts from Electric Wholesale Sales and Purchased Energy Costs Paid, respectively.

We record an Allowance for Doubtful Accounts to reduce accounts receivable for revenue amounts that are estimated to be uncollectible. TEP, UNS Gas and UNS Electric establish an allowance for doubtful accounts based on historical collection experience and any specific customer collection issues that are identified. TEP's Allowance for Doubtful Accounts was \$4 million at December 31, 2009, and \$17 million at December 31, 2008. See Note 4. UNS Gas and UNS Electric's combined Allowance for Doubtful Accounts was \$2 million at December 31, 2009 and \$3 million at December 31, 2008.

TEP recognizes revenue from operating Springerville Unit 3 and Unit 4 as contract services and materials are provided. Expenses are recorded in the respective line item of the income statement based on the nature of service or materials provided.

**INVENTORY**

TEP records fuel inventory, primarily coal, at weighted average cost. TEP uses full absorption costing, under which all handling and procurement costs are included in the cost of the inventory. Examples of these costs include direct material, direct labor, overhead costs and transportation costs. See Note 4 regarding fuel purchase contracts.

Materials and supplies inventories are recorded at cost. Materials and supplies consist of transmission and distribution line construction and repair materials and generating station and transmission and distribution substation repair materials.

**FUEL AND PURCHASED ENERGY COSTS****TEP and UNS Electric Purchased Power and Fuel Adjustment Clause (PPFAC)**

As a result of the 2008 TEP Rate Order, TEP began deferring differences between purchased energy costs and the recovery of such costs in rates effective January 1, 2009. UNS Electric also defers differences between purchased energy costs and the recovery of such costs in rates. Where applicable, fuel cost over-recoveries (the excess of fuel costs recovered in base rates over fuel costs incurred) are deferred as current regulatory liabilities and under-recoveries (the excess of fuel costs incurred over fuel costs recovered in base rates) are deferred as current regulatory assets. The 2008 TEP Rate Order required TEP to credit, with interest, \$58 million of Fixed CTC true-up revenues charged to customers from May 2008 to November 2008, through the PPFAC. See Note 2.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****UNS Gas Purchased Gas Adjustor (PGA)**

UNS Gas defers differences between gas purchase costs and the recovery of such costs in base rates under a Purchased Gas Adjustor (PGA) mechanism. The PGA mechanism addresses the volatility of natural gas prices and allows UNS Gas to recover its commodity costs through a price adjustor. The PGA factor, computed monthly, is a calculation of 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. The difference between the actual cost of UNS Gas' gas supplies and transportation contracts and that cost which is currently allowed by the ACC is deferred and recovered or repaid through the PGA mechanism. When under-or over-recovery trigger points are met, UNS Gas may request a PGA surcharge or surcredit with the goal of collecting or returning the amount deferred from or to customers, with interest, over a twelve-month period. See Note 2.

**INCOME TAXES**

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 current income tax rates, which are expected to be in effect when the deferred tax assets and liabilities are realized or settled.

Tax benefits are recognized in the financial statements when it is more likely than not that a tax position will be sustained upon examination by the tax authorities based on the technical merits of the position. The tax benefit recorded is the largest amount that is more than 50% likely to be realized upon ultimate settlement with the tax authority. In calculating the benefit to be recognized we assume the tax authorities have full knowledge of the position and all relevant facts. Interest Expense includes interest accrued by UniSource and TEP on tax positions taken on tax returns which have not been reflected in the financial statements.

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 Notes 2 and 9.

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

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

**TAXES OTHER THAN INCOME TAXES**

TEP, UNS Gas and UNS Electric act as conduits or collection agents for sales tax, utility taxes, franchise fees and regulatory assessments. We record liabilities payable to governmental agencies as customers are billed for these taxes and assessments. These amounts are not reflected in the income statement.

**EMISSION ALLOWANCES**

The Environmental Protection Agency (EPA) issues emission allowances to qualifying utilities based on past operational history. Each allowance permits emission of one ton of sulfur dioxide (SO<sub>2</sub>) in its vintage year or a subsequent year. TEP receives an allotment of these SO<sub>2</sub> emission allowances annually; UNS Electric and UED do not receive SO<sub>2</sub> emission allowances since neither has coal-fired generation. When issued from the EPA, these SO<sub>2</sub> emission allowances have no book value for accounting purposes but may be sold if TEP does not need them for operations. TEP may also purchase additional SO<sub>2</sub> emission allowances if needed. Purchased SO<sub>2</sub> emission allowances are recorded at cost. Beginning in January 2009, as a result of the 2008 TEP Rate Order, TEP will credit 50% of the gains from the sales of SO<sub>2</sub> emission allowances to the PPFAC. The remaining 50% of gains from sales of excess SO<sub>2</sub> emission allowances will be reflected as a reduction of Other Operations and Maintenance expense on TEP's income statement when title passes and in the operating activities section of the statement of cash flows. 100% of gains from sales of excess SO<sub>2</sub> emission allowances were reflected as a reduction of Other Operations and Maintenance expense in 2007 and 2008. No allowances were sold in 2009.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****RENEWABLE ENERGY STANDARDS TARIFF (REST) AND RENEWABLE ENERGY CREDITS (RECs)**

Arizona adopted a mandatory renewables portfolio standard that requires TEP and UNS Electric to engage in renewable energy activities, allowing cost recovery under REST. Arizona uses RECs as a form of measurement of compliance to the REST requirements encouraging construction and consumption of renewable energy. RECs are created each time one KWh of renewable energy is generated or when qualifying renewable equipment is manufactured. An escalating percentage of retail electric sales determine the annual REC requirement. RECs may be used to satisfy compliance requirements anytime after creation with no expiration date. We have the option of generating our own RECs, or purchasing RECs which are usually bundled with renewable power purchases. RECs may be sold if we do not need them for operations.

**DERIVATIVE FINANCIAL INSTRUMENTS****Risks and Overview**

TEP, UNS Gas and UNS Electric are exposed to energy price risk associated with their gas and purchased power requirements, volumetric risk associated with their seasonal load and operational risk associated with their power plants, transmission and transportation systems. The energy price risk is mitigated through the PPFAC and PGA mechanisms which provide an adjustment to TEP, UNS Gas and UNS Electric's retail rates to recover the actual costs of purchased power, gas, transmission and transportation. TEP, UNS Gas and UNS Electric further reduce their energy price risk through a variety of derivative and non-derivative instruments. The objectives for entering into such contracts include: creating price stability for TEP, UNS Gas and UNS Electric; to ensure TEP, UNS Gas and UNS Electric can meet their load and reserve requirements; and reducing TEP, UNS Gas and UNS Electric's exposure to price volatility that may result from delayed recovery under the PPFAC or PGA. See Note 2 for further information regarding regulatory matters.

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

Although TEP's gains and losses on trading activities, if any, are recorded on a net basis in the income statement, we report the related cash receipts and cash payments separately in the statement of cash flows. We present cash collateral and derivative assets and liabilities, associated with the same counterparty, separately in our financial statements and we bifurcate all derivatives into their current and long-term portions on the balance sheet.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****Cash Flow Hedges**

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 accounts for cash flow hedges as follows:

- The effective portion of the changes in the fair value of TEP's interest rate swaps and TEP's six-year power purchase swap agreement are recorded in AOCI and the ineffective portion, if any, is recognized in earnings.
- When TEP determines a contract is no longer effective in offsetting the changes in cash flow of a hedged item, TEP recognizes the changes in fair value in earnings. The unrealized gains and losses at that time remain in AOCI and are reclassified into earnings as the underlying hedged transaction occurs.

We formally assess, both at the hedge's inception and on an ongoing basis, whether the derivatives have been and are expected to remain highly effective in offsetting changes in the cash flows of hedged items. We discontinue hedge accounting when: (1) the derivative is no longer effective in offsetting changes in the fair value or cash flows of a hedged item; (2) the derivative expires or is sold, terminated, or exercised; (3) it is no longer probable that the forecasted transaction will occur; or (4) we determine that designating the derivative as a hedging instrument is no longer appropriate.

**Mark-to-Market**

- **TEP**

TEP's non-trading hedges, such as forward power purchase contracts indexed to gas, short-term forward power sales contracts, or call and put options (gas collars), that did not qualify for cash flow hedge accounting treatment or did not qualify for the normal scope exception, are considered mark-to-market transactions. TEP hedges a portion of its monthly natural gas exposure for plant fuel, gas-indexed purchased power and spot market purchases with fixed price contracts for a maximum of three years. Beginning in December 2008, as a result of the 2008 TEP Rate Order, which permits recovery in the PPFAC of hedging transactions, unrealized gains and losses are recorded as either a regulatory asset or regulatory liability only to the extent they qualify for recovery under the PPFAC mechanism.

TEP enters into certain energy-related derivatives for trading purposes which are forward power purchase and sale contracts entered into purely to profit from market price changes. The net trading activities represent a very small portion (less than 1%) of TEP's revenue from wholesale sales in 2007 and 2008. In 2009, TEP had no trading activity. As unrealized gains and losses resulting from changes in the market prices of trading derivatives are not recoverable in the PPFAC, unrealized gains and losses are recorded in the income statement in Electric Wholesale Sales.

- **UNS Electric**

UNS Electric hedges a portion of its purchased power exposure to fixed price and natural gas-indexed contracts with forward power purchases or financial gas swaps. In April 2009, UNS Electric also began using call and put options, creating price stability and reducing exposure to price volatility that may result in delayed recovery under the PPFAC.

- **UNS Gas**

UNS Gas enters into derivatives such as forward gas purchases and gas swaps, creating price stability and reducing exposure to natural gas price volatility that may result in delayed recovery under the PGA. Beginning in December 2008, unrealized gains and losses are recorded as either a regulatory asset or regulatory liability, as the UNS Gas PGA mechanism permits the recovery of the prudent cost of hedging contracts.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****Normal Purchase and Normal Sale**

UNS Gas, UNS Electric and TEP enter into forward energy purchase and sales contracts, including call options, to support the current load forecast and contracts entered into with a counterparty with load serving requirements or generating capacity. These contracts are not required to be marked-to-market and are accounted for on an accrual basis. On an ongoing basis we evaluate our counterparties for non-performance risk to ensure it does not impact our ability to obtain the normal scope exception.

**2007 and 2008 Accounting Summary**

Prior to December 2008, we recorded unrealized gains and losses on derivative instruments as follows:

- TEP's interest rate swaps, TEP's forward contracts to sell excess capacity, and TEP and UNS Gas' forward gas swaps were recorded in AOCI;
- TEP's non-trading hedges such as forward power purchase contracts indexed to gas, and TEP's forward purchase and sale trading contracts were recorded in the income statement; and
- All other commodity contracts were reflected on the balance sheet as either regulatory assets or regulatory liabilities.

**SHARE-BASED COMPENSATION**

UniSource Energy has a stock-based long-term incentive plan. UniSource Energy measures the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with some limited exceptions). Compensation costs are recognized over the period during which an employee is required to provide service in exchange for the award which typically is the vesting period. Compensation cost is not recognized for anticipated forfeitures of equity instruments prior to vesting. Our share-based compensation plans are described more fully in Note 11.

**RECLASSIFICATIONS AND OTHER ADJUSTMENTS****Springerville Unit 1**

In 2006, we recorded an investment in 14.14% of Springerville Unit 1 lease equity transaction as a lease restructuring. We subsequently determined that the transaction was best characterized as a purchase of an interest in a trust accounted for using equity method accounting. As a result, at June 30, 2009, UniSource Energy and TEP recorded a net increase to Net Income of less than \$0.5 million, after tax. The net adjustment recorded in 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. In addition, UniSource Energy and TEP recorded a \$19 million increase to capital lease assets, a \$4 million increase to accumulated amortization, a \$3 million increase to capital lease obligations, and an \$11 million decrease to investment in lease debt.

**Renewable Energy and Demand Side Management (DSM) Revenues**

UniSource Energy and TEP reclassified renewable revenue of \$5 million and \$3 million in 2008, and \$7 million and \$5 million in 2007, respectively, from Other Revenue to Electric Retail Sales in the Statements of Income. These reclassifications had no effect on Net Income.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****Dividend Equivalents**

In September 2009, UniSource Energy and TEP recorded dividends of \$0.9 million and \$0.8 million, respectively, for dividend equivalents that should have been recorded between 2005 and 2008.

**Other**

In June 2009, TEP recorded approximately \$1 million (\$0.6 million after-tax) of additional depreciation for plant improvements that should have been recorded prior to 2009. TEP also recorded an after-tax gain of \$1.5 million related to proceeds from a company owned life insurance policy that should have been recorded prior to 2009.

**TEP 2008 Rate Order**

In the TEP 2008 Rate Order, the Arizona Corporation Commission (ACC) granted TEP a Purchased Power and Fuel Adjustment Clause (PPFAC) which allows recovery of actual fuel and purchased power costs, including demand charges, transmission costs, and prudent settlement costs of contracts for hedging fuel and purchased power costs. UNS Electric has a similar PPFAC mechanism. UNS Gas has a Purchased Gas Adjuster (PGA) mechanism which allows UNS Gas to recover its actual commodity costs, including transportation. See Note 2.

To provide more information regarding the components of the PPFAC/PGA and to be comparable with the 2009 presentation, UniSource Energy and TEP made the following reclassifications to the statements of income for the years ended December 31, 2008 and December 31, 2007.

- UniSource Energy and TEP reclassified Transmission expenses of \$19 million and \$11 million in 2008, and \$16 million and \$9 million in 2007, respectively, from Other Operations and Maintenance to Transmission, a component of Total Fuel and Purchased Energy;
- UniSource Energy and TEP reclassified capital lease expenses of \$5 million in 2007 and 2008 from Interest on Capital Leases to Fuel; and
- UniSource Energy reclassified \$11 million in 2008 and \$5 million in 2007 of over-recovered PPFAC and PGA expenses from Purchased Energy, Transmission, and Fuel to Increase (Decrease) to reflect PPFAC/PGA Recovery Treatment, a component of Total Fuel and Purchased Energy.

These reclassifications had no effect on Net Income.

**NOTE 2. REGULATORY MATTERS****1999 Settlement Agreement**

We believe that the 1999 Settlement Agreement contemplated that TEP's retail rates for generation service would have been market-based beginning January 1, 2009. As part of the 2008 TEP Rate Order, TEP and all the parties to the 2008 Proposed Settlement Agreement relinquished all claims related to the 1999 Settlement Agreement and the ACC order adopting the 1999 Settlement Agreement.

**1999 Transition Recovery Asset**

TEP's Transition Recovery Asset consisted of generation-related regulatory assets and a portion of TEP's generation plant asset costs. Transition costs that were recovered through the Fixed CTC included: (1) the Transition Recovery Regulatory Asset; (2) a small portion of generation-related plant assets included in Plant in Service on the balance sheet; and (3) excess capacity deferrals related to operating and capital costs associated with Springerville Unit 2 which were amortized as an off-balance sheet regulatory asset through 2003. In May 2008, TEP fully amortized the remaining Transition Recovery Asset balance, as costs were fully recovered through rates. TEP amortized \$24 million and \$78 million of the asset to the income statement in 2008 and 2007, respectively. TEP also amortized \$2 million and \$8 million of generation-related plant assets in 2008 and 2007, respectively.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10**

In May 2007, the ACC ordered that TEP's current Fixed CTC revenue remain at its then-current level until the effective date of a final order in the TEP 2008 proposed settlement agreement proceeding. As of December 1, 2008, when new rates went into effect, TEP had collected \$58 million of true-up revenues and recorded a \$58 million reserve for Fixed CTC revenue to be refunded against its Electric Retail Sales in 2008. The 2008 TEP Rate Order requires TEP to return the Fixed CTC true-up revenues to customers by reducing the PPFAC balance.

**TEP 2008 Rate Order**

The 2008 TEP Rate Order, issued by the ACC and effective December 1, 2008, provides for a cost of service rate methodology for TEP's generation assets; an average base rate increase of 6% over TEP's previous retail rates; a fuel rate included in base rates of 2.9 cents per kilowatt-hour (kWh); a PPFAC effective January 1, 2009; a base rate increase moratorium through January 1, 2013; and a waiver of any claims under the 1999 Settlement Agreement.

As a result of the 2008 TEP Rate Order, TEP reapplied regulatory accounting to its generation operations. In addition, in December 2008, TEP began deferring its mark-to-market adjustments for derivative instruments that are expected to be recovered through the PPFAC as either regulatory assets or regulatory liabilities.

**Purchased Power and Fuel Adjustment Clause (PPFAC)**

The TEP PPFAC became effective January 1, 2009. The PPFAC allows recovery of fuel and purchased power costs, including demand charges 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 of 0.18 cents per kWh became effective on April 1, 2009, and will be updated each year. The forward component is based on the forecasted fuel and purchased power costs for the twelve-month period from April 1 to March 31 the following year, less the average base cost of fuel and purchased power of approximately 2.9 cents per kWh, which is embedded in base rates.
- 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.

TEP credited Fixed CTC revenue to be refunded (\$58 million collected from May 2008 to November 30, 2008) to customers as an offset to the PPFAC rate. This credit will offset 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 the next 36 to 48 months beginning April 1, 2009.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT**

**Audit Committee**  
**2/19/10**

The following table shows the balance of Regulatory Liabilities – (Over-) Under-Recovered Purchased Energy Costs:

	December 31, 2009	December 31, 2008
	-Millions of Dollars-	
<b>Fixed CTC Revenue to be Refunded within the next 12 months; Included in Current Liabilities</b>	<b>\$ (9)</b>	<b>\$ (14)</b>
Under-Recovered Purchased Energy Costs – Regulatory Basis as Billed to Customers	\$ 29	\$ —
Estimated Purchased Energy Costs Recovered through Accrued Unbilled Revenues	(9)	—
Fixed CTC Revenue to be Refunded	(37)	(44)
<b>Total Included in Deferred Credits and Other Liabilities</b>	<b>\$ (17)</b>	<b>\$ (44)</b>

The \$12 million amortization of the Fixed CTC Revenue to be Refunded appears in the accompanying income statements as an addition to retail revenues in 2009. The \$21 million 2009 change in Under-Recovered Purchased Energy Costs appears in the income statement as a credit to fuel and purchased power costs in the line item Increase (Decrease) to Reflect PPFAC Recovery Treatment.

For the purposes of reconciling fuel and purchased power to PPFAC revenues, including the credited forward component, TEP will credit the allocable retail portion of the following against the PPFAC eligible costs: 100% of short-term wholesale revenues; 10% of the annual profit on trading activity; and 50% of the revenues from the sales of SO<sub>2</sub> emission allowances. TEP had no trading activities or sales of SO<sub>2</sub> emission allowances in 2009.

Rate-making Methodology for Generation Assets

Rates for generation service are based on a cost-of-service methodology. All generation assets acquired by TEP between the end of the rate case test year (December 31, 2006) and the end of the base rate increase moratorium period (December 31, 2012) shall be included in TEP's rate base at their respective original depreciated cost, subject to subsequent review and approval by the ACC in future rate cases. Luna is included in TEP's original cost rate base at its net book value of \$48 million as of December 31, 2006.

Springerville Unit 1 non-fuel costs are being recovered through base rates at \$25.67 per kilowatt (kW) per month, which approximates the levelized cost of Springerville Unit 1 through the remainder of the lease term.

Depreciation and Net Negative Salvage

On December 1, 2008, TEP implemented new depreciation rates that include a component for net negative salvage value for all generation assets except Luna and new depreciation rates for distribution and general plant assets that will extend the depreciable lives of these assets. The estimated net impact on the income statement is to increase depreciation expense \$9 million per year.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT**

**Audit Committee**  
**2/19/10**

**Impact of Reapplying Regulatory Accounting to TEP's Generation Operations**

In December 2008, as a result of the 2008 TEP Rate Order, TEP reappplied regulatory accounting to its generation operations and TEP recorded the following adjustments:

	<u>Income Statement</u>	<u>Balance Sheet</u>		
		<u>Regulatory Asset</u>		
	<u>(Gain)/Loss</u>	<u>Current</u>	<u>Non Current</u>	<u>AOCI</u>
Recorded in Fuel:				
San Juan Coal Contract Amendment	\$ (9)	\$ 1	\$ 8	\$ —
Retiree Health Care and Final Mine Reclamation Costs	(15)	—	15	—
Unrealized Gains (Losses) on Derivative Contracts (PPFAC)	(8)	14	5	(11)
Deregulation Costs Recorded in O&M	(1)	1	—	—
Property Taxes	(7)	7	—	—
Pension and Other Postretirement Benefits	—	—	14	(14)
<b>Pre-Tax Impact of Reapplying Regulatory Accounting</b>	<b>\$ (40)</b>	<b>\$ 23</b>	<b>\$ 42</b>	<b>\$ (25)</b>

- San Juan Coal Contract Amendment costs of \$9 million, incurred by TEP in 2000, will be amortized over 9 years beginning in December 2008.
- Final Mine Reclamation and Retiree Health Care Costs represent costs associated with TEP's jointly-owned facilities at San Juan, Four Corners and Navajo. TEP is required to recognize the present value of its liability associated with final reclamation and retiree health care obligations. As TEP is permitted to fully recover these costs through the PPFAC when the costs are invoiced by the miners, TEP recorded a regulatory asset.
- Unrealized gains (losses) on derivative instruments (PPFAC) are contracts for which the settled amounts will be recovered through the PPFAC. As TEP expects to recover the final settled amounts through the PPFAC, TEP reclassified amounts previously recorded in the income statement and in AOCI to a regulatory asset.
- Deregulation Costs represent deferred expenses that TEP incurred to comply with various ACC deregulation orders.
- Property taxes related to generation assets which will be recovered in rates as cash is paid rather than as costs are accrued.
- Pension and Other Postretirement Benefits represent the underfunded status of TEP's defined benefit and other postretirement benefit plans prior to December 2008. As TEP expects to recover these costs in rates, TEP reclassified amounts previously recorded in AOCI to a regulatory asset.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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**Income Statement Impact of Applying Regulatory Accounting**

Regulatory accounting had the following impacts on TEP's reported net income, in addition to the impact of reapplying regulatory accounting to its generation operations for 2008:

	Years Ended December 31,		
	2009	2008	2007
	-Millions of Dollars-		
<b>Operating Revenues</b>			
Amortization of the Fixed CTC Revenue to be Refunded	\$ (12)	\$ —	\$ —
<b>Operating Expenses</b>			
Depreciation (related to Net Cost of Removal for Interim Retirements)	41	10	7
Deferral of Under-Recovered Purchased Energy Costs	(21)	—	—
Deferral of Unrealized losses on Derivative Instruments	10	—	—
Amortization of 1999 Transition Recovery Asset	—	24	78
Other	3	—	—
<b>Interest Expense</b>			
Long-Term Debt (Amortization of Loss on Reacquired Debt Costs)	—	1	1
<b>Income Taxes</b>	—	4	5
<b>Net Increase to Income Statement</b>	<u>\$ 21</u>	<u>\$ 39</u>	<u>\$ 91</u>

If TEP had not applied regulatory accounting in these years, the above amounts would have been reflected in the income statements in prior or future periods.

**Renewable Energy Standard Tariff (REST)**

Through December 31, 2009, and December 31, 2008, TEP collected \$29 million and \$9 million in customer surcharges, of which \$18 million and \$3 million were expensed for REST projects, respectively. At December 31, 2009 and December 31, 2008, \$17 million and \$6 million were recorded as a current regulatory liability to be used in future periods, respectively.

The approved REST adjustor mechanism allows TEP to file an application with the ACC to apply any shortage or surplus in the prior year's program expenses to the subsequent year's REST surcharge.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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The following table summarizes TEP's regulatory assets and liabilities:

	December 31,	
	2009	2008
-Millions of Dollars-		
<b>Current Regulatory Assets</b>		
Property Tax Deferrals <sup>(1)</sup>	\$ 16	\$ 16
Derivative Instruments <sup>(2)</sup>	4	14
Deregulation Costs <sup>(3)</sup>	4	4
Other Current Regulatory Assets <sup>(4)</sup>	3	3
<b>Total Current Regulatory Assets</b>	<b>27</b>	<b>37</b>
<b>Pension and Other Postretirement Benefits <sup>(7)</sup></b>	<b>80</b>	<b>107</b>
<b>Regulatory Assets – Other</b>		
Derivative Instruments <sup>(2)</sup>	5	5
Deregulation Costs <sup>(3)</sup>	7	10
San Juan Coal Contract Amendment <sup>(5)</sup>	7	8
Final Mine Reclamation Costs <sup>(8)</sup>	9	8
Retiree Health Care Costs <sup>(8)</sup>	6	6
Unamortized Loss on Reacquired Debt <sup>(9)</sup>	4	5
Other Regulatory Assets <sup>(4)</sup>	1	1
<b>Total Regulatory Assets — Other</b>	<b>39</b>	<b>43</b>
<b>Income Taxes Recoverable through Future Revenues <sup>(6)</sup></b>	<b>18</b>	<b>20</b>
<b>Current Regulatory Liabilities</b>		
Over-Recovered Purchased Energy Costs	(9)	(14)
Renewable Energy Standards Tariff (REST) <sup>(10)</sup>	(17)	(6)
Other Current Regulatory Liabilities <sup>(4)</sup>	—	(1)
<b>Total Current Regulatory Liabilities</b>	<b>(26)</b>	<b>(21)</b>
<b>Other Regulatory Liabilities</b>		
Net Cost of Removal for Interim Retirements <sup>(11)</sup>	(163)	(123)
Over-Recovered Purchased Energy Costs	(17)	(44)
<b>Total Other Regulatory Liabilities</b>	<b>(180)</b>	<b>(167)</b>
<b>Total Net Regulatory Assets (Liabilities)</b>	<b>\$ (42)</b>	<b>\$ 19</b>

Regulatory assets are either being collected in rates or are expected to be collected through rates in a future period, as described below:

- Property Tax is recorded based on historical ratemaking treatment allowing recovery as costs are paid out, rather than as costs are accrued. TEP records a regulatory property tax asset related to its generation assets. While these assets do not earn a return, the costs are fully recovered in rates over an approximate six month period.
- Derivative Instruments represent the unrealized gains or losses on contracts entered into to hedge the variability of purchased energy costs and short-term wholesale sales that are expected to be recovered through the PPFAC. As a result of the 2008 TEP Rate Order and the approval of the PPFAC, TEP deferred the gains and losses on certain contracts that meet the recovery criteria under the PPFAC requirements.
- Deregulation costs represent deferred expenses that TEP incurred to comply with various ACC deregulation orders, the recovery of which has been authorized by the ACC in the 2008 TEP Rate Order. These assets are included in rate base and consequently earn a return. TEP will recover these costs through rates over a four-year period, beginning in December 2008.



**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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4. TEP does not earn a return on these assets.
5. San Juan Coal Contract Amendment costs of \$15 million were incurred by TEP in 2000. In the 2008 TEP Rate Order, the ACC approved the recovery of \$9 million of these costs over a nine-year period beginning in December 2008. The current portion is recorded in Other Assets. These assets do not earn a return.
6. Income Taxes Recoverable Through Future Revenues, while not included in rate base, are amortized over the life of the assets. TEP does not earn a return on these assets.
7. Pension Assets. TEP records a regulatory pension and postretirement benefit asset related to its employees. Based on past regulatory actions, TEP expects to recover these costs in rates. TEP does not earn a return on these assets.
8. Final Reclamation and Retiree Health Care Costs represent costs associated with TEP's jointly-owned facilities at San Juan, Four Corners and Navajo. TEP is required to recognize the present value of its liability associated with final reclamation and retiree health care obligations. As TEP is permitted to fully recover these costs through the PPFAC when the costs are invoiced by the miners, TEP recorded a regulatory asset. TEP expects to recover these costs over the life of the mines, which is estimated to be between 17 and 34 years. TEP does not earn a return on these assets.
9. Unamortized Loss on Reacquired Debt Costs is amortized for rate recovery over the remaining life of the related debt instruments over a period of 21 years. TEP does not earn a return on these costs.

Regulatory liabilities represent items that TEP expects to pay to customers through billing reductions in future periods or use for the purpose for which they were collected from customers, as described below:

10. Renewable Energy Standards Tariff (REST) represents the REST surcharge collected in excess of qualified renewable expenditures.
11. Net Cost of Removal for Interim Retirements represents an estimate of the cost of future asset retirement obligations net of salvage value. These are amounts collected through revenue for the net cost of removal of interim retirements for transmission, distribution, general and intangible plant which are not yet expended. TEP collects through revenue the net cost of removal of interim retirements for generation plant, which it has not yet expended.

**Future Implications of Discontinuing Application of Regulatory Accounting**

TEP continues to apply regulatory accounting to its regulated operations. TEP regularly assesses whether it can continue to apply regulatory accounting to these operations. If TEP stopped applying regulatory accounting to its regulated operations, regulatory pension assets would be reflected in AOCI, and it would write-off the remaining related balances of its regulatory assets as an expense and its regulatory liabilities as income on its income statement. Based on the regulatory assets balances, net of regulatory liabilities, at December 31, 2009, if TEP had stopped applying regulatory accounting to its regulated operations, it would have recorded an extraordinary after-tax gain of \$74 million and an after-tax loss in AOCI of \$48 million. While future regulatory orders and market conditions may affect cash flows, TEP's cash flows would not be affected if TEP stopped applying regulatory accounting.

**UNS GAS RATES AND REGULATION****2008 General Rate Case Filing**

In November 2008, UNS Gas filed a general rate case (on a cost of service basis) with the ACC requesting a total rate increase of 6% to cover a revenue deficiency of \$10 million. The case uses a June 30, 2008 test year. UNS Gas expects the ACC to rule on its rate case in the first half of 2010.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT**

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**Purchase Gas Adjustor (PGA) 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. All purchased gas commodity costs, including transportation, increase the PGA bank, a balancing account. UNS Gas recovers these costs or returns amounts over-collected from/to ratepayers through a PGA rate. The PGA rate includes the following two components:

- (1) The **PGA factor**, computed monthly, is a calculation of 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. Effective December 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.
- (2) 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 basis, UNS Gas is required to request a **PGA surcredit** with the goal of returning the over-collected balance to customers over a period deemed appropriate by the ACC.

The PGA surcharge was \$0.05 cents per therm from January 2007 through April 2007. The PGA surcredit was \$0.04 cents per therm from October 2007 through April 2008. From May 2008 through October 2009, there was no surcharge or surcredit in effect. 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.

Based on current projections of gas prices, UNS Gas believes that the current PGA rates will allow it to timely recover its gas costs. However, changes in the market price for gas, sales volumes and surcharges could significantly change the PGA bank balance in the future.

The following table shows the balance of over-recovered purchased gas costs:

	December 31,	
	2009	2008
	-Millions of Dollars-	
Under (Over) Recovered Purchased Gas Costs – Regulatory Basis as Billed to Customers	\$ (2)	\$ 5
Estimated Purchased Gas Costs Recovered through Accrued Unbilled Revenues	(8)	(10)
<b>Over-Recovered Purchased Gas Costs (PGA) Included as a Current Regulatory Liability</b>	<b>\$ (10)</b>	<b>\$ (5)</b>

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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**Other Regulatory Assets and Liabilities**

In addition to the Over-Recovered Purchased Gas Costs, UNS Gas has the following Regulatory Assets and Liabilities:

	December 31,	
	2009	2008
	-Millions of Dollars-	
<b>Current Assets</b>		
Derivative Instruments	\$ 5	\$ 7
<b>Pension Obligations</b>	2	3
<b>Other Regulatory Assets</b>		
Derivative Instruments	3	6
Other Regulatory Assets	1	1
<b>Other Regulatory Liabilities</b>		
Net Cost of Removal for Interim Retirements	(20)	(19)

Regulatory assets are either being collected in rates or are expected to be collected through rates in a future period, as described below:

- Derivative instruments represent the unrealized gains or losses on contracts entered into to hedge the variability of purchased energy costs that are expected to be recovered through the PGA. UNS Gas does not earn a return on these costs.
- Pension assets represent the unfunded status of UNS Gas' share of the UES pension and other postretirement benefit plans that it expects, based on past regulatory actions, to recover through rates. UNS Gas does not earn a return on these costs.
- Other Regulatory Assets consist of its 2007 rate case costs which are recoverable over 3 years. In addition, UNS Gas deferred its 2008 rate case costs and its low income assistance program costs. UNS Gas requested recovery of these costs in its 2008 rate case filing. UNS Gas does not earn a return on these costs.

Regulatory liabilities represent items that UNS Gas expects to pay to customers through billing reductions in future periods or use for the purpose for which they were collected from customers, as described below:

- Net Cost of Removal for Interim Retirements represents an estimate of the cost of future asset retirement obligations. These are amounts collected through revenue for the net cost of removal of interim retirements for which removal costs have not yet been expended. In December 2007, to comply with ACC requirements, UNS Gas reclassified \$12 million of Net Cost of Removal for Interim Retirements from Accumulated Depreciation to a regulatory liability.

**Income Statement Impact of Applying Regulatory Accounting**

If UNS Gas had not applied regulatory accounting, net income would have been \$6 million higher in 2009, and \$9 million higher in 2007 as UNS Gas would have been able to recognize over-recovered purchased energy costs and unrealized gains on its commodity derivative instruments as a reduction to its expenses in the income statement rather than record a regulatory liability. Net income would have been \$4 million lower in 2008 as UNS Gas would have recognized under-recovered purchased energy costs and unrealized losses on its commodity derivative instruments as an expense to its income statement rather than a reduction to its regulatory liability.

**Future Implications of Discontinuing Application of Regulatory Accounting**

UNS Gas regularly assesses whether it can continue to apply regulatory accounting. If UNS Gas stopped applying regulatory accounting to its regulated operations, regulatory pension assets would be reflected in AOCI and UNS Gas would write-off the remaining related balance of its regulatory assets as an expense and write-off its regulatory liabilities as income on its income statement. Based on the regulatory asset and liability balances, if UNS Gas had stopped applying regulatory accounting to its regulated operations, it would have recorded an extraordinary after-tax gain of \$13 million and an after-tax loss in AOCI of \$1 million at December 31, 2009. Discontinuing application of regulatory accounting would not affect UNS Gas cash flows.

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**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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**UNS ELECTRIC RATES AND REGULATION**

**2008 UNS Electric Rate Order**

In the May 2008 rate order, the ACC approved a rate increase of 2.5% (\$4 million) effective June 2008. As a result of the May 2008 rate order limiting recovery of deferred rate case costs, UNS Electric expensed \$0.3 million of the \$0.6 million deferred costs in May 2008.

**2009 General Rate Case Filing**

In April 2009, UNS Electric filed a general rate case with the ACC (on a cost of service basis) requesting a total rate increase of 7.4% to cover a revenue deficiency of \$13.5 million. The case uses a December 31, 2008 test year. Hearings before an ACC administrative law judge concluded in February 2010. UNS Electric expects the ACC to rule on its rate case in the second half of 2010.

**Purchased Power and Fuel Adjustment Clause (PPFAC)**

UNS Electric's retail rates include a PPFAC, which allows for a separate surcharge or surcredit to the base rate for delivered purchased power to collect under-recovered or return over-recovered costs. Allowable PPFAC costs include fuel, purchased power (less proceeds from most wholesale sales) and transmission costs. The PPFAC approved in UNS Electric's last rate case in May 2008, allows recovery of fuel and purchased power costs incurred to provide service to retail customers, including demand charges and the prudent costs of contracts for hedging fuel and purchased power costs.

The PPFAC mechanism has a forward component and a true-up component. The forward component of the PPFAC rate is based on the difference between forecasted fuel and purchased power costs and the base cost of fuel and purchased power included in base rates. The true-up component reconciles the previous year's actual fuel and purchased power costs with the amounts collected through base and PPFAC rates and credits or recovers that amount to or from customers in the subsequent PPFAC year. The PPFAC rate will be updated on June 1 of each year, beginning June 1, 2009.

On June 1, 2009, a PPFAC credit of approximately 1.06 cents per kWh took effect. The PPFAC rate from June 1, 2008 to May 31, 2009, was a charge of approximately 1.5 cents per kWh. Base rates of approximately 7.1 cents per kWh have been in effect since June 1, 2008. The retail rates prior to June 2008, included a charge for fuel and purchased power of approximately 7 cents per kWh (base rate recovery of 5.2 cents per kWh and a transmission surcharge of 1.8 cents per kWh).

The following table shows the balance of over-recovered purchased power costs:

	<b>December 31, 2009</b>	<b>December 31, 2008</b>
	-Millions of Dollars-	
(Over-)Recovered Purchased Power Costs – Regulatory Basis as Billed to Customers	\$ (1)	\$ —
Estimated Purchased Power Costs Recovered through Accrued Unbilled Revenues	(4)	(7)
<b>(Over-)Recovered Purchased Power Costs (PPFAC) Included as a Current Regulatory Liability</b>	<b>\$ (5)</b>	<b>\$ (7)</b>

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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**2/19/10****Purchased Power Agreement**

In June 2008, UED and UNS Electric entered into a 5-year Power Purchase Agreement (PPA) under which UED sells all the output of BMGS to UNS Electric. 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. UNS Electric accounts for the PPA as an operating lease. The costs associated with the PPA are recoverable through UNS Electric's PPFAC.

**Regulatory Assets and Liabilities**

UNS Electric's regulatory assets and liabilities were as follows:

	December 31,	
	2009	2008
	-Millions of Dollars-	
<b>Current Regulatory Assets</b>		
Derivatives	\$ 9	\$ 17
<b>Other Regulatory Assets</b>		
Derivative Instruments	2	7
Pension Assets	2	3
Other	1	—
<b>Current Regulatory Liabilities</b>		
REST	(1)	(1)
Over-Recovered Purchased Power Costs	(5)	(6)
<b>Other Regulatory Liabilities</b>		
Net Cost of Removal for Interim Retirements	(12)	(11)

Regulatory assets are either being collected in rates or are expected to be collected through rates in a future period, as described below:

- Derivative instruments represent the unrealized gains or losses on contracts entered into to hedge the variability of purchased energy costs that are expected to be recovered through the PPFAC. UNS Electric does not earn a return on these costs.
- Pension assets represent the unfunded status of UNS Electric's share of the UES pension and other postretirement benefit plans that it expects, based on past regulatory actions, to recover through rates. UNS Electric does not earn a return on these costs.
- Rate case costs included in Other Regulatory Assets are included in rate base and consequently earn a return. The recovery period is 3 years.

Regulatory liabilities represent items that UNS Electric expects to pay to customers through billing reductions in future periods or use for the purpose for which they were collected from customers, as described below:

- Renewable Energy Standards Tariff (REST) represents the REST surcharge collected in excess of qualified renewable expenditures. The ACC approved a REST surcharge for UNS Electric, effective June 1, 2008, to allow UNS Electric to recover the cost of qualified renewable expenditures, such as payments to customers who have renewable energy resources or the incremental cost of renewable power generated or purchased by UNS Electric. Any surcharge collected in excess of qualified renewable expenditures will be reflected in the financial statements as a current regulatory liability. Conversely, qualified renewable expenditures in excess of the REST surcharge will be reflected as a current regulatory asset. The REST plan includes an adjustor mechanism which allows UNS Electric to file an application with the ACC to apply any shortage or surplus in the prior year's program expenses to the subsequent year's REST surcharge.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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- UNS Electric defers differences between purchased energy costs and the recovery of such costs in revenues. Future billings are adjusted for such deferrals through use of a PPFAC approved by the ACC. The PPFAC allows for a revenue surcharge or surcredit (that adjusts the customer's rate for delivered purchased power) to collect or return under- or over-recovery of costs.
- Net Cost of Removal for Interim Retirements represents an estimate of the cost of future asset retirement obligations. These are amounts collected through revenue for the net cost of removal of interim retirements for which removal costs have not yet been expended. In June 2008, to comply with ACC expectations, UNS Electric reclassified \$7 million of Net Cost of Removal for Interim Retirements from Accumulated Depreciation to a regulatory liability.

**Income Statement Impact of Applying Regulatory Accounting**

If UNS Electric had not applied regulatory accounting, net income would have been \$7 million higher in 2009 and \$1 million higher in 2007, as UNS Electric would have been able to recognize over-recovered purchased power costs and unrealized gains on its commodity derivative instruments as a credit to the income statement rather than record an increase to regulatory liabilities. If UNS Electric had not applied regulatory accounting, net income would have been \$15 million lower in 2008 as UNS Electric would have recognized under-recovered purchased energy and unrealized losses on its commodity derivative instruments as an expense to its income statement, rather than as regulatory assets or a reduction to its regulatory liabilities.

**Future Implications of Discontinuing Application of Regulatory Accounting**

UNS Electric regularly assesses whether it can continue to apply regulatory accounting to its operations. If UNS Electric stopped applying regulatory accounting to its regulated operations, regulatory pension assets would be reflected in AOCI and it would write-off the remaining related balances of its regulatory assets as an expense and would write-off its regulatory liabilities as income on its income statement. Based on the regulatory asset and liability balances, if UNS Electric had stopped applying regulatory accounting to its regulated operations, it would have recorded an extraordinary after-tax gain of \$3 million and an after-tax loss in AOCI of \$1 million at December 31, 2009. Discontinuing application of regulatory accounting would not affect UNS Electric's cash flows.

**NOTE 3. SEGMENT AND RELATED INFORMATION**

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

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

The UniSource Energy and UES holding companies, Millennium, and UED are included in All Other.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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Reconciling adjustments consist of the elimination of intersegment revenue which were due to the following transactions and they are eliminated in consolidation:

	Reportable Segments			
	TEP	UNS Gas	UNS Electric	Other
-Millions of Dollars-				
<b>Intersegment Revenue</b>				
<b>2009:</b>				
Wholesale Sales – TEP to UNSE	\$ 23	\$ —	\$ —	\$ —
Wholesale Sales – UNSE to TEP	—	—	4	—
Wholesale Sales – UED to UNSE	—	—	—	12
Gas Revenue – UNSG to UNSE & UED	—	5	—	—
Other Revenue – TEP to Affiliates <sup>(1)</sup>	8	—	—	—
Other Revenue – Millennium to TEP & UNSE <sup>(2)</sup>	—	—	—	16
Other Revenue – TEP to UNSE <sup>(3)</sup>	3	—	—	—
Total Intersegment Revenue	\$ 34	\$ 5	\$ 4	\$ 28
<b>2008:</b>				
Wholesale Sales – TEP to UNSE	\$ 24	\$ —	\$ —	\$ —
Wholesale Sales – UNSE to TEP	—	—	9	—
Wholesale Sales – UED to UNSE	—	—	—	7
Gas Revenue – UNSG to UNSE & UED	—	8	—	—
Other Revenue – TEP to Affiliates <sup>(1)</sup>	8	—	—	—
Other Revenue – Millennium to TEP & UNSE <sup>(2)</sup>	—	—	—	16
Other Revenue – TEP to UNSE <sup>(3)</sup>	2	—	—	—
Total Intersegment Revenue	\$ 34	\$ 8	\$ 9	\$ 23
<b>2007:</b>				
Other Revenue – TEP to Affiliates <sup>(1)</sup>	\$ 7	\$ —	\$ —	\$ —
Other Revenue – Millennium to TEP & UNSE <sup>(2)</sup>	—	—	—	15
Total Intersegment Revenue	\$ 7	\$ —	\$ —	\$ 15

(1) TEP provides corporate services (finance, accounting, tax, information technology services, etc.) to UniSource Energy and its subsidiaries. See Note 14.

(2) A Millennium subsidiary provides a supplemental workforce and meter reading services to TEP and UNS Electric.

(3) TEP provides control area services to UNS Electric. See Note 14.

Other significant reconciling adjustments include intercompany interest between UniSource Energy and UED, the elimination of investments in subsidiaries held by UniSource Energy and reclassifications of deferred tax assets and liabilities.



**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT**

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2007	Reportable Segments				Reconciling Adjustments	UniSource Energy
	TEP	UNS Gas	UNS Electric	All Other		
-Millions of Dollars-						
<b>Income Statement</b>						
Operating Revenues – External	\$ 1,064	\$ 151	\$ 169	\$ (3)	\$ —	\$ 1,381
Operating Revenues – Intersegment	7	—	—	15	(22)	—
Depreciation and Amortization	120	8	13	—	—	141
Amortization of Transition Recovery Asset	78	—	—	—	—	78
Interest Income	16	1	—	2	—	19
Interest Expense	111	7	6	8	—	132
Income Tax Expense (Benefit)	36	3	3	(3)	—	39
Net Income (Loss)	53	4	5	(4)	—	58
<b>Cash Flow Statement</b>						
Capital Expenditures	(162)	(23)	(38)	(22)	—	(245)
<b>Balance Sheet</b>						
Total Assets	2,573	276	231	1,077	(971)	3,186
Investments in Equity Method Entities	3	—	—	28	—	31

**NOTE 4. COMMITMENTS AND CONTINGENCIES**

**TEP COMMITMENTS**

**Firm Purchase Commitments**

At December 31, 2009, TEP had various firm non-cancelable purchase commitments and operating leases as described in the table below.

	Purchase Commitments						Total
	2010	2011	2012	2013	2014	Thereafter	
-Millions of Dollars-							
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
Total Firm Purchase Commitments	135	65	48	43	41	146	478
Operating Lease Payments	1	—	—	—	—	—	1
Total Unrecognized Firm Commitments	\$ 136	\$ 65	\$ 48	\$ 43	\$ 41	\$ 146	\$ 479

**Fuel and Purchased Power Contracts**

TEP has long-term contracts for the purchase and delivery of coal and natural gas with various expiration dates from 2010 through 2020. Amounts paid under these contracts depend on actual quantities purchased and delivered. Some of these contracts include a price adjustment clause that will affect the future cost. The table above also includes approximately \$1 million under take-or-pay arrangements if certain minimum quantities are not transported in 2010. TEP expects to spend more to meet its fuel requirements than the minimum purchase obligations outlined above.

TEP has entered into agreements with utilities and other energy suppliers for purchased power to meet system load and energy requirements, replace generation from company-owned units under maintenance and during outages, and meet operating reserve obligations. In general, these contracts provide for capacity payments and energy

payments based on actual power taken under the contracts. These contracts expire in various years between 2010 and 2015. Certain of these contracts are at a fixed price per MW and others are indexed to natural gas prices. The commitment amounts included in the table are based on projected market prices as of December 31, 2009.

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**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
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Starting January 1, 2009, fuel, purchased power and transmission costs are recoverable from customers through a PPFAC.

TEP has, subject to ACC approval, entered into three long-term purchase power agreements with developing renewable energy generation facilities that extend for periods of 15 to 20 years. The facilities are expected to begin commercial operation between 2010 and 2012. TEP is required to purchase the full output of each facility. Expected capacities range from 2 MW to 25 MW. TEP is only obligated to pay for actual energy delivered. There are no minimum payment obligations under these contracts.

**Operating Leases**

TEP's aggregate operating lease expense, which is primarily for office facilities and computer equipment, with varying terms, provisions, and expiration dates, totaled \$1 million in 2009, \$1 million in 2008 and \$2 million in 2007.

**Environmental Regulation**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 released 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.

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 can not deduct these penalties for income tax purposes. TEP did not incur any stipulated penalties at San Juan in 2009. The installation of new pollution control equipment designed to remedy all emission violations was completed in 2008 for San Juan Unit 1 and in 2009 at San Juan Unit 2.

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 100 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 SO<sub>2</sub> 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 had sufficient SO<sub>2</sub> Emission Allowances to comply with the SO<sub>2</sub> regulations. 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.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT**

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**UNS GAS and UNS ELECTRIC COMMITMENTS**

At December 31, 2009, UNS Gas had firm non-cancelable purchase commitments for fuel, including transportation, as described in the table below.

	<b>Purchase Commitments</b>						<b>Total</b>
	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>Thereafter</u>	
	-Millions of Dollars-						
Total Unrecognized Firm Commitments – Fuel	<u>\$ 19</u>	<u>\$ 14</u>	<u>\$ 5</u>	<u>\$ 3</u>	<u>\$ 3</u>	<u>\$ 23</u>	<u>\$ 67</u>

UNS Gas purchases gas from various suppliers at market prices. However, UNS Gas' risk of loss due to increased costs (as a result of changes in the market price of fuel) is mitigated through the use of the PGA, which provides for pass-through of most fuel costs to customers. UNS Gas' forward gas purchase agreements expire through 2012. Certain of these contracts are at a fixed price per mmbtu and others are indexed to natural gas prices. UNS Gas has firm transportation agreements with capacity sufficient to meet its load requirements. These contracts expire in various years between 2011 and 2024.

At December 31, 2009, UNS Electric had various firm non-cancelable purchase commitments as described in the table below.

	<b>Purchase Commitments</b>						<b>Total</b>
	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>Thereafter</u>	
	-Millions of Dollars-						
Purchased Power	<u>\$ 67</u>	<u>\$ 23</u>	<u>\$ 14</u>	<u>\$ 47</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 151</u>
Transmission	<u>2</u>	<u>2</u>	<u>1</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>5</u>
Total Unrecognized Firm Commitments	<u>\$ 69</u>	<u>\$ 25</u>	<u>\$ 15</u>	<u>\$ 47</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 156</u>

UNS Electric enters into agreements with various energy suppliers for purchased power at market prices to meet its energy requirements. In general, these contracts provide for capacity payments and energy payments based on actual power taken under the contracts. These contracts expire in various years through 2013. Certain of these contracts are at a fixed price per MW and others are indexed to natural gas prices. The commitment amounts included in the table above are based on market prices as of December 31, 2009.

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 2011 and 2017. However, the effects of both purchased power and transmission cost adjustments are mitigated through a purchased power rate-adjustment mechanism.

UNS Electric has subject to ACC approval, entered into one long-term purchase power agreement with a renewable energy generation facility that extends for 20 years. The facility is expected to begin commercial operation in 2011. UNS Electric is required to purchase the full output of the facility with an expected minimum capacity of 7 MW. UNS Electric is only obligated to pay for actual energy delivered. There is no minimum payment obligation under this contract.

In addition, UNS Gas and UNS Electric's combined operating lease expense, which is primarily for office facilities and computer equipment, with varying terms, provisions, and expiration dates was \$1 million in each of the years 2009, 2008 and 2007. UNS Gas and UNS Electric's estimated future minimum payments under non-cancelable operating leases are approximately \$1 million per year from 2010 to 2011 and \$2 million thereafter.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee  
2/19/10****MILLENNIUM COMMITMENTS**

Millennium has a remaining obligation to fund investments for capital and operations of less than \$1 million over the next 3 years.

**UNISOURCE ENERGY COMMITMENTS**

UniSource Energy purchased land and plans to construct a new headquarters building on the site. The construction contract has not yet been executed; however, firm commitments related to the design phase have been made requiring expenditures of \$3 million over the next 18 months.

**TEP CONTINGENCIES****El Paso Electric Transmission**

In 2006, El Paso filed a complaint to the FERC claiming that TEP must request service under El Paso's Open Access Transmission Tariff (OATT) in order to transmit power from Luna to TEP's system. TEP filed a counter complaint stating that TEP has existing rights under a 1982 Tucson-El Paso Transmission Agreement and, therefore, is not required to pay for transmission service under El Paso's OATT. On November 13, 2008, the FERC issued an order supporting TEP's position. In December 2008, El Paso refunded to TEP \$10 million paid for transmission service from Luna during the pendency of this dispute and interest of \$1 million. On January 14, 2009, FERC granted El Paso's request for a rehearing of this matter. TEP is no longer accruing for transmission service under El Paso's OATT, however, due to the rehearing, TEP deferred recognition of a reduction in transmission expense.

In December 2008, TEP filed a complaint in the United States Federal District Court against El Paso seeking a \$2 million reimbursement from El Paso 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 September 10, 2009, the District Court denied El Paso's motion to dismiss TEP's complaint and stayed the proceeding pending a final resolution of the FERC proceedings and any appeal. TEP cannot predict the timing or outcome of these lawsuits.

**Claims Related to Navajo Generating Station**

In June 1999, the Navajo Nation filed suit against Salt River Project, several Peabody Coal Company entities (including Peabody Western Coal Company, the coal supplier to Navajo Generating Station), Southern California Edison Company, and other defendants in the U.S. District Court for the District of Columbia (D.C. Lawsuit). The D.C. Lawsuit alleges, among other things, that the defendants obtained a favorable coal royalty rate of the lease agreements under which Peabody mines coal by improperly influencing the outcome of a federal administrative process pursuant to which the royalty rate was to be adjusted. The suit seeks \$600 million in damages, treble damages, and punitive damages of not less than \$1 billion, and the ejection of defendants from all possessory interests and Navajo Tribal lands arising out of the primary coal lease. In July 2001, the U.S. District Court dismissed all claims against Salt River Project. In March 2008, the U.S. District Court lifted a stay that had been in place since October 2004 and referred pending discovery related motions to a Magistrate judge. In June 2009, the District Court ordered the parties to complete fact discovery by February 2010. In February 2010, the District Court issued an Amended Scheduling Order which extends the February 2010 discovery deadline and sets other procedural deadlines at various dates between March 2010 and February 2011.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
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In 2004, Peabody Western Coal Company (Peabody) filed a complaint in the Circuit Court for the City of St. Louis, Missouri against the participants at Navajo, including TEP (7.5% owner), for reimbursement of royalties and other costs arising out of the D.C. Lawsuit. In July 2008, the parties entered into a joint stipulation of dismissal of these claims which was approved by the Circuit Court. TEP cannot predict whether the lawsuit will be refiled based upon the final outcome of the D.C. Lawsuit.

**Claims Related to San Juan Coal Company**

San Juan Coal Company, the coal supplier to San Juan, through leases with the federal government and the State of New Mexico, owns coal interests with respect to an underground mine. Certain gas producers have oil and gas leases with the federal government, the State of New Mexico and private parties in the area of the underground mine. These gas producers allege that San Juan Coal Company's underground coal mining operations have or will interfere with their gas production and will reduce the amount of natural gas that they would otherwise be entitled to recover. San Juan Coal Company has compensated certain gas producers for any remaining gas production from a well when it was determined that mining activity was close enough to warrant shutting down the well. These settlements, however, do not resolve all potential claims by gas producers in the underground mine area. TEP cannot estimate the impact of any future claims by these gas producers on the cost of coal at San Juan.

**Environmental Reclamation at Remote Generating Stations**

TEP currently pays on-going reclamation costs related to the coal mines which supply the remote generating stations, and it is probable that TEP will have to pay a portion of final reclamation costs upon mine closure. When a reasonable estimate of final reclamation costs is available, the liability is recognized as a cost of coal over the remaining term of the corresponding coal supply agreement. At December 31, 2009 and 2008, TEP recorded liabilities of \$10 million and \$9 million, respectively, based on our \$17 million obligation at the expiration dates of the coal supply agreements in 2011 through 2017.

TEP's PPFAC, as approved in the 2008 TEP Rate Order, allows TEP to pass-through most fuel costs, including final reclamation costs, to customers. Therefore, in 2008, when TEP reapplied regulatory accounting to its generation operations, TEP reclassified these costs from fuel expense to a regulatory asset. TEP will increase the regulatory asset and the liability over the remaining life of the coal supply agreements on an accrual basis, and will recover the regulatory asset through the PPFAC as final mine reclamation costs are paid to the coal suppliers.

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

**TEP Wholesale Accounts Receivable and Allowances**

TEP's Accounts Receivable from Electric Wholesale Sales included \$16 million of receivables at December 31, 2008 related to sales to the California Power Exchange (CPX) and the California Independent System Operator (CISO) in 2001 and 2000. TEP had recognized a related reserve of \$14 million. There are currently pending several proceedings and lawsuits concerning the California energy crisis related to the FERC, wholesale power suppliers, Southern California Edison Company, Pacific Gas and Electric Company, the CPX and the CISO, where the parties are seeking refunds of \$4 million. TEP's cost to litigate these matters is expected to increase substantially as the proceedings enter the trial phase in 2010. In light of this, TEP re-engaged in settlement discussions with the plaintiffs in the fourth quarter of 2009. In December 2009, based on those settlement discussions, TEP wrote off the remaining receivable balance of \$2 million and accrued an additional liability of \$2 million. TEP believes it is adequately reserved but we cannot predict the final outcome of the settlement discussions or lawsuits at this time.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee  
2/19/10****Tucson to Nogales Transmission Line**

TEP and UNS Electric are parties to a project development agreement for the joint construction of an approximately 60-mile transmission line from Tucson to Nogales, Arizona. UNS Electric's participation in this project was initiated in response to an order by the ACC to improve reliability to UNS Electric's retail customers in Nogales, Arizona.

In 2002, the ACC approved the location and construction of the proposed 345-kV line along a route identified as the Western Corridor route subject to a number of conditions, including obtaining all required permits from state and federal agencies. The U.S. Forest Service subsequently identified a preference for a route identified as the Central Corridor route in the final Environmental Impact Statement for the project. TEP is considering options for the project including potential new routes. If a decision is made to pursue an alternative route, approvals will be needed from the ACC, the Department of Energy, U.S. Forest Service, Bureau of Land Management, and the International Boundary and Water Commission. As of 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 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.

**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 SMRCRA 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.

**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 are:

- UES' guarantee of senior unsecured notes issued by UNS Gas (\$100 million) and by UNS Electric (\$100 million),
- UES' guarantee of the \$60 million UNS Gas/UNS Electric Revolver, and
- 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.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT**

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To the extent liabilities exist under these contracts, the liabilities are included in our 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.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT**

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**NOTE 5. UTILITY PLANT AND JOINTLY-OWNED FACILITIES**

**UTILITY PLANT**

The following table shows Utility Plant in Service by company and major class.

	<b>December 31, 2009</b>				
	- Millions of Dollars -				
	TEP	UNS Gas	UNS Electric	UED	UniSource Energy
<b>Plant in Service:</b>					
Electric Generation Plant	\$ 1,527	\$ —	\$ 17	\$ 61	\$ 1,605
Electric Transmission Plant	682	—	30	4	716
Electric Distribution Plant	1,110	—	185	—	1,295
Gas Distribution Plant	—	216	—	—	216
Gas Transmission Plant	—	18	—	—	18
General Plant	178	15	11	—	204
Computer Software	82	1	4	—	87
Electric Plant Held for Future Use	5	—	1	—	6
<b>Total Plant in Service</b>	<b>\$ 3,584</b>	<b>\$ 250</b>	<b>\$ 248</b>	<b>\$ 65</b>	<b>\$ 4,147</b>
<b>Utility Plant under Capital Leases</b>	<b>\$ 720</b>	<b>\$ —</b>	<b>\$ 1</b>	<b>\$ —</b>	<b>\$ 721</b>

	<b>December 31, 2008</b>				
	- Millions of Dollars -				
	TEP	UNS Gas	UNS Electric	UED	UniSource Energy
<b>Plant in Service:</b>					
Electric Generation Plant	\$ 1,398	\$ —	\$ 17	\$ 58	\$ 1,473
Electric Transmission Plant	660	—	29	4	693
Electric Distribution Plant	1,044	—	163	—	1,207
Gas Distribution Plant	—	201	—	—	201
Gas Transmission Plant	—	18	—	—	18
General Plant	173	14	9	—	196
Computer Software	71	1	4	—	76
Electric Plant Held for Future Use	5	—	1	—	6
<b>Total Plant in Service</b>	<b>\$ 3,351</b>	<b>\$ 234</b>	<b>\$ 223</b>	<b>\$ 62</b>	<b>\$ 3,870</b>
<b>Utility Plant under Capital Leases</b>	<b>\$ 701</b>	<b>\$ —</b>	<b>\$ 1</b>	<b>\$ —</b>	<b>\$ 702</b>

**TEP'S UTILITY OPERATING STATISTICS**

	For Years Ended December 31,				
	2009	2008	2007	2006	2005
<b>Generation and Purchased Power — kWh (000)</b>					
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
<b>Total Generation and Purchased Power</b>	<b>13,374,098</b>	<b>14,425,975</b>	<b>14,136,960</b>	<b>13,501,681</b>	<b>12,863,053</b>
Less Losses and Company Use	948,463	954,643	944,024	885,120	806,168
<b>Total Energy Sold</b>	<b>12,425,635</b>	<b>13,471,332</b>	<b>13,192,936</b>	<b>12,616,561</b>	<b>12,056,885</b>

TEP's unamortized computer software costs were \$31 million as of December 31, 2009 and \$29 million as of December 31, 2008. UNS Gas and UNS Electric had unamortized computer software costs of \$1 million as of December 31, 2009 and as of December 31, 2008.

All TEP Utility Plant under Capital Leases is used in TEP's generation operations and amortized over the primary lease term as described in Notes 1 and 6. The amortization expense on capital lease assets was \$26 million in 2009, and \$25 million in each of 2008 and 2007.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT**

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The following table reconciles the gross investment in utility plant to net investment in utility plant, segregated between regulated and non-regulated utility plant.

	December 31, 2009						
	Regulated				Non-Regulated		
	T&D	TEP Gen	Total Plant	UNS Gas	UNS Electric	UED Plant	UniSource Energy Total Plant
				Total Plant	Total Plant		
-Millions of Dollars-							
Gross Plant in Service	\$ 2,057	\$ 1,527	\$ 3,584	\$ 250	\$ 248	\$ 65	\$ 4,147
Less Accumulated Depreciation and Amortization	913	669	1,582	15	52	3	1,652
Net Plant in Service	<u>\$ 1,144</u>	<u>\$ 858</u>	<u>\$ 2,002</u>	<u>\$ 235</u>	<u>\$ 196</u>	<u>\$ 62</u>	<u>\$ 2,495</u>
	December 31, 2008						
	Regulated				Non-Regulated		
	T&D	TEP Gen	Total Plant	UNS Gas	UNS Electric	UED Plant	UniSource Energy Total Plant
				Total Plant	Total Plant		
-Millions of Dollars-							
Gross Plant in Service	\$ 1,953	\$ 1,398	\$ 3,351	\$ 234	\$ 223	\$ 62	\$ 3,870
Less Accumulated Depreciation and Amortization	865	667	1,532	9	39	1	1,581
Net Plant in Service	<u>\$ 1,088</u>	<u>\$ 731</u>	<u>\$ 1,819</u>	<u>\$ 225</u>	<u>\$ 184</u>	<u>\$ 61</u>	<u>\$ 2,289</u>

The category T&D includes all transmission and distribution Plant in Service. The category Gen includes the generation assets. Rates for utility operations appearing in this table are set by the ACC on a cost-of-service basis, and are accounted for under the provisions of regulatory accounting for all periods except those assets owned by UED.

The depreciable lives as of December 31, 2009 were as follows:

Major Class of Utility Plant in Service	TEP	UNS Gas, UNS Electric & UED
Electric Generation Plant	7-59 years	38-49 years
Electric Transmission Plant	10-50 years	20-50 years
Electric Distribution Plant	28-60 years	23-50 years
Gas Distribution Plant	n/a	30-65 years
Gas Transmission Plant	n/a	30-55 years
General Plant	5-31 years	5-40 years
Intangible Plant	3-15 years	5-32 years

See *TEP Utility Plant* in Note 1 and *TEP Capital Lease Obligations* in Note 6.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****JOINTLY-OWNED FACILITIES**

At December 31, 2009, TEP's interests in jointly-owned generating stations and transmission systems were as follows:

	<u>Ownership Percentage</u>	<u>Plant in Service</u>	<u>Construction Work in Progress</u>	<u>Accumulated Depreciation</u>
		-Millions of Dollars-		
San Juan Units 1 and 2	50.0%	\$ 416	\$ 5	\$ 209
Navajo Station Units 1, 2 and 3	7.5	138	3	86
Four Corners Units 4 and 5	7.0	89	5	67
Transmission Facilities	7.5 to 95.0	243	—	177
Luna Energy Facility	33.3	50	—	—
Total		<u>\$ 936</u>	<u>\$ 13</u>	<u>\$ 539</u>

TEP has financed or provided funds for the above facilities and TEP's share of their operating expenses is reflected in the income statements. See Note 4 for commitments related to TEP's jointly-owned facilities.

**NOTE 6. DEBT, CREDIT FACILITIES, AND CAPITAL LEASE OBLIGATIONS**

Long-term debt matures more than one year from the date of the financial statements. We summarize UniSource Energy and TEP's long-term debt in the statements of capitalization.

**UNISOURCE ENERGY DEBT****Convertible Senior Notes**

UniSource Energy has \$150 million of 4.50% Convertible Senior Notes (Convertible Senior Notes) due 2035. The Convertible Senior Notes are unsecured and are not guaranteed by TEP or any other UniSource Energy subsidiary. 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 adjustment in certain circumstances.

Beginning on March 5, 2010, UniSource Energy will have the option to redeem the Convertible Senior Notes, in whole or in part, for cash at a price equal to 100% of the principal amount plus accrued interest. Holders of the Convertible Senior Notes may require UniSource Energy to repurchase the Convertible Senior Notes, in whole or in part, for cash on March 1, 2015, 2020, 2025 and 2030, or if certain change of control transactions occur, or if our common stock is no longer listed on a national securities exchange. The repurchase price will be 100% of the principal amount of the Convertible Senior Notes plus accrued interest.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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**2/19/10****TEP DEBT****2009 Sale and Redemption of Bonds**

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 (Coconino PCC) 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 in whole or in part for cash 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 on November 2, 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, Arizona Pollution Control Bonds.

**Collateral Trust Bonds**

In 1998, TEP issued a total of \$140 million, 7.5% Collateral Trust Bonds, due August, 2008. TEP retired these bonds in 2008. See 2008 Pima A and 2008 Pima B Bonds below.

**2008 Pima A Bonds**

In March 2008, The Industrial Development Authority of Pima County (Pima Authority) issued, for the benefit of TEP, approximately \$91 million of its 2008 Series A tax-exempt, unsecured, 6.375% bonds (2008 Pima A Bonds) due September 1, 2029. 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. 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, TEP received the payment of the redemption price.

TEP used the redemption proceeds to repay \$75 million in revolving loans outstanding under its revolving credit facility. The remaining proceeds were used in May 2008 to redeem \$10 million of the \$138 million 7.5% Collateral Trust Bonds due August 2008. TEP capitalized \$1 million of costs related to the issuance of the 2008 Pima A Bonds and will amortize these costs through August 2029, the term of the bonds.

Interest on the 2008 Pima A Bonds is payable semi-annually, commencing on September 1, 2008.

Beginning in March 2013, TEP will have the option to redeem the 2008 Pima A Bonds, in whole or in part, for cash, at a price equal to 100% of the principal amount, plus accrued interest.

**2008 Pima B Bonds**

In June 2008, the Pima Authority issued for TEP's benefit, \$130 million of its 2008 Series B tax-exempt variable rate IDBs (2008 Pima B Bonds) due September 1, 2029. The 2008 Pima B Bonds were supported by a letter of credit (LOC) issued under the TEP 2008 Letter of Credit Facility. The LOC was secured by \$132 million of 1992 Mortgage Bonds. 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.

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TEP deposited the redemption proceeds with the trustee for its 7.5% Collateral Trust Bonds. In August 2008, the deposit was applied to the payment of \$128 million of principal plus \$5 million of accrued interest on such bonds at maturity. TEP was required to deposit these funds with the trustee pursuant to amendments dated May 30, 2008 to the TEP Credit Agreement and the 2008 TEP Letter of Credit Facility. These amendments allowed TEP to exclude the \$128 million of Collateral Trust Bonds to be retired in August 2008 from Total Indebtedness for the calculation of its leverage ratio covenant at June 30, 2008.

While in the variable rate mode, the 2008 Pima B Bonds accrued interest at a rate which reset weekly. The average weekly interest rate on the 2008 Pima B Bonds ranged from 0.50% to 8.25%, with an average rate of 2.03% for 2008, and from 0.15% to 0.75%, with an average rate of 0.34% for 2009. The peak weekly rate of 8.25% occurred in mid-September 2008, when the short-term debt markets began to experience significant disruptions related to the creditworthiness of several large financial institutions. The rate on this debt was 0.30% and 0.75%, respectively, as of December 31, 2009 and 2008. TEP paid a remarketing fee of 10 basis points (bps) to the remarketing agent of the bonds, an LOC fee of 65 bps to the lenders, and an LOC issuing fee of 12.5 bps to the issuing bank.

In January 2010, TEP converted the interest on the 2008 Pima B to a fixed rate. The 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. Accordingly, the associated LOC was terminated on January 12, 2010 and the mortgage bonds were canceled.

TEP capitalized \$1 million of costs related to the issuance of the 2008 Pima B Bonds and will amortize these costs through August 2029. TEP capitalized approximately \$2 million of costs related to the reoffering in January 2010 and will amortize these costs through August 2029.

**Variable Rate Industrial Development Bonds (IDBs)**

Weighted average interest rates on this variable rate tax-exempt IDBs debt ranged from 0.25% to 0.79% during 2009, and from 0.55% to 8.09% during 2008, and the average interest rate on such debt was 0.41% in 2009, and 2.11% in 2008. In August 2009, TEP entered into an interest rate swap that had the effect of converting \$50 million of variable rate industrial development bonds to a fixed rate of 2.4% from September 2009 through September 2014.

**1992 Mortgage**

TEP's 1992 Mortgage creates liens on and security interests in most of TEP's utility plant assets, with the exception of Springerville Unit 2. San Carlos Resources Inc., a wholly-owned subsidiary of TEP, holds title to Springerville Unit 2. Utility Plant under Capital Leases is not subject to such liens or available to TEP creditors, other than the lessors. The net book value of TEP's utility plant subject to the lien of the indenture was approximately \$2 billion at December 31, 2009.

**TEP CAPITAL LEASE OBLIGATIONS**

In January 2010, TEP entered into an agreement to purchase 100% of the equity interest in Sundt Unit 4 from the owner participant for \$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 repay the remaining Sundt Unit 4 lease obligation of \$5 million.

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The terms of TEP's other capital leases are as follows:

- The Springerville Common Facilities Leases have an initial term to December 2017 for one lease and January 2021 for the other two leases, subject to optional renewal periods of two or more years through 2025.
- The Springerville Unit 1 Leases have an initial term to January 2015 and provide for renewal periods of three or more years through 2030.
- The Springerville Coal Handling Facilities Leases have an initial term to April 2015 and provide for one renewal period of six years, then additional renewal periods of five or more years through 2035.

Effective with commercial operation of Springerville Unit 3 in July 2006 and Springerville 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. Lease expenses reimbursed by Tri-State were \$7 million in each of 2009, 2008 and 2007.

TEP has agreed with the owners of Springerville Units 3 and 4 that, upon expiration of the Springerville Coal Handling Facilities and Common Leases, TEP will acquire the leased interest in the facilities at fixed prices of \$120 million in 2015, \$38 million in 2017, and \$68 million in 2021. Upon such acquisitions by TEP, each of the owners of Unit 3 and Unit 4 have the obligation to purchase or continue renting from TEP a 17% and 14% interest, respectively, in such facilities. On or before the Springerville Unit 1 Lease expiration date, TEP will determine if it will either: a) purchase the assets at the fair market value; b) extend the lease term; or c) not continue with an interest in Springerville Unit 1.

In January 2010, through scheduled lease payments, TEP reduced its capital lease obligation by \$40 million.

**Investments in Springerville Lease Debt and Equity**

In March 2009, TEP purchased \$31 million of Springerville Unit 1 lease debt which included a premium that will be amortized over the remaining term of the lease debt. TEP's investment in Springerville Unit 1 lease debt totaled \$88 million at December 31, 2009 and \$59 million at December 31, 2008. TEP also held an undivided equity ownership interest in the Springerville Unit 1 lease totaling \$37 million at December 31, 2009 and \$48 million at December 31, 2008. TEP held an investment in Springerville Coal Handling Facilities lease debt totaling \$7 million at December 31, 2009 and \$20 million at December 31, 2008.

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

In June 2006 and in 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 the amortizing principal balances as follows:

Outstanding at December 31, 2009	Fixed Ratio	LIBOR Spread
\$35 million	5.77%	1.625%
\$23 million	3.18%	1.625%
\$7 million	3.32%	1.625%

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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These interest rate swaps have been recorded by TEP as a cash flow hedge for financial reporting purposes. See Note 18.

**UNS ELECTRIC LONG-TERM DEBT**

UNS Electric has \$100 million of senior unsecured debt; \$50 million at 6.5%, due 2015 and \$50 million at 7.1%, due 2023 (UNS Electric 2008 Long-Term Debt). The UNS Electric Long-Term Debt is guaranteed by UES. The notes may be prepaid with a make-whole call premium reflecting a discount rate equal to an equivalent maturity U.S. Treasury security yield plus 50 basis points.

The UNS Electric Long-Term Debt 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 covenants.

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.

**UNS GAS LONG-TERM DEBT**

UNS Gas has \$100 million of senior unsecured notes outstanding, consisting of \$50 million at 6.23%, due August 2011, and \$50 million at 6.23%, due August 2015. The notes may be prepaid with a make-whole call premium reflecting a discount rate equal to an equivalent maturity U.S. Treasury security yield plus 50 basis points. UES guarantees the notes.

UNS Gas must meet a leverage test and an interest coverage test to issue additional debt or to pay dividends. UNS Gas may refinance existing debt and incur up to \$7 million in short-term debt.

The UNS Gas Long-Term Debt 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 Gas was in compliance with the terms of its note purchase agreement.

**UNISOURCE ENERGY CREDIT AGREEMENT**

The UniSource Energy Credit Agreement consists of a \$30 million amortizing term loan facility and a \$70 million revolving credit facility and matures in August 2011. UniSource Energy's obligations under the UniSource Credit Agreement are secured by a pledge of the capital stock of Millennium, UES and UED.

At December 31, 2009 the following balances were outstanding:

	<u>Current</u> <u>Liabilities</u>	<u>Long-</u> <u>Term Debt</u>	<u>Total</u>	<u>Current</u> <u>Liabilities</u>	<u>Long-</u> <u>Term Debt</u>	<u>Total</u>
	- Millions of Dollars-					
	<b>December 31, 2009</b>			December 31, 2008		
Revolver	\$ —	\$ 31	\$ 31	\$ —	\$ 43	\$ 43
Term Loan	\$ 6	\$ 3	\$ 9	\$ 6	\$ 9	\$ 15
Weighted Average Interest Rate on the Revolver and Term Loan	—	—	1.48%	—	—	2.48%

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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We have included the revolver borrowings in Long-Term Debt as UniSource Energy has the ability and the intent to have outstanding borrowings for the next twelve months. As of February 25, 2010, outstanding borrowings under the UniSource Energy Credit Agreement were \$15 million.

Principal payments of \$1.5 million on the outstanding term loan are due quarterly, with the balance due at maturity. 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 Energy Credit Agreement restricts additional indebtedness, liens, mergers, sales of assets, and certain investments and acquisitions. We must also meet: (1) a minimum cash flow to interest coverage ratio for UniSource Energy on a standalone basis and (2) a maximum leverage ratio on a consolidated basis. In September 2008, as a result of higher than expected fuel and purchased power costs, UniSource Energy amended the UniSource Energy Credit Agreement to provide more flexibility to meet the leverage ratio test for the next four calendar quarters, ending June 30, 2009. In February 2009, the leverage ratio in the UniSource Credit Agreement was further amended through August 2011. The leverage ratio is calculated as the ratio of consolidated total indebtedness to consolidated earnings before interest, taxes, depreciation and amortization (EBITDA). As of December 31, 2009, UniSource Energy was in compliance with the terms of its credit agreement.

UniSource Energy may pay dividends if, after giving effect to the dividend payment, it has more than \$15 million of unrestricted cash and unused revolving credit.

**TEP CREDIT AGREEMENT**

The TEP Credit Agreement consists of a \$150 million revolving credit facility, and a \$341 million LOC facility which supports \$329 million of tax-exempt Variable Rate IDBs. The TEP Credit Agreement matures in August 2011 and is secured by \$491 million of mortgage bonds issued under the 1992 Mortgage, which creates a lien on and security interest in most of TEP's utility plant assets. The \$150 million revolving credit facility may be used for revolver borrowings as well as to issue letters of credit. TEP issues letters of credit to provide credit enhancements to counterparties for power and gas procurement and hedging activities.

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, TEP may pay dividends to UniSource Energy.

In September 2008, as a result of higher than expected fuel and purchased power costs, TEP amended the TEP Credit Agreement, to provide more flexibility to meet the leverage ratio test for the next four calendar quarters, ending June 30, 2009. The leverage ratio is calculated as the ratio of consolidated total indebtedness to EBITDA. As of December 31, 2009, TEP was in compliance with all the terms of its credit agreement.

As of December 31, 2009, TEP had \$35 million in borrowings and \$1 million outstanding in letters of credit under its revolving credit facility. As of December 31, 2008, TEP had \$10 million in loans outstanding under its revolving credit facility and \$1 million outstanding in letters of credit. The revolving loan balances are included in Current Liabilities in the UniSource Energy and TEP balance sheets. The outstanding letters of credit are off-balance sheet obligations of TEP. As of February 25, 2009, TEP had \$50 million in borrowings and \$1 million outstanding in letters of credit under its revolving credit facility.

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In April 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. (See 2008 Pima B Bonds above).

Interest rates and fees under the 2008 TEP Letter of Credit Facility were based on a pricing grid tied to TEP's credit ratings. Based on TEP's current credit ratings, the letter of credit fees were 0.65% per annum during the first two years and 0.775% in the third year.

The TEP Letter of Credit Facility contained substantially the same restrictive covenants as the TEP Credit Agreement described above. As of December 31, 2009, TEP was in compliance with all the terms of the TEP Letter of Credit Facility. The TEP Letter of Credit Facility was terminated in January 2010 at the time of the fixed rate conversion of the 2008 Pima B Bonds (See 2008 Pima B Bonds above).

**UNS GAS/UNS ELECTRIC CREDIT AGREEMENT**

The UNS Gas/UNS Electric Revolver is a \$60 million revolving credit facility which matures in August 2011. Either UNS Gas or UNS Electric 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. The UNS Gas/UNS Electric Revolver may be used to issue letters of credit, as well as for revolver borrowings. UNS Gas and UNS Electric issue letters of credit, which are off-balance sheet obligations, to support power and gas purchases and hedges.

UNS Gas and UNS Electric each have the option of paying interest at LIBOR plus 1.0% or the greater of the federal funds rate plus 0.5% or the agent bank's reference rate.

The UNS Gas/UNS Electric Revolver contains restrictions on additional indebtedness, liens, dividends, mergers and sales of assets. The UNS Gas/UNS Electric Revolver 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.

The borrowings under the UNS Gas/UNS Electric Revolver were as follows:

	<u>UNS</u> <u>Gas</u>	<u>UNS</u> <u>Electric</u>	<u>UNS</u> <u>Gas</u>	<u>UNS</u> <u>Electric</u>
	-Millions of Dollars-			
	<u>December 31, 2009</u>		<u>December 31, 2008</u>	
Balance on the Revolver	\$ —	\$ —	\$ —	\$ 8
Weighted Average Interest Rate	—	—	—	1.5%
Outstanding Letters of Credit	\$ —	\$ 11	\$ 10	\$ 7

At December 31, 2008, UNS Electric's borrowings under the UNS Gas/UNS Electric Revolver were excluded from Current Liabilities and presented as Long-Term Debt, as UNS Electric has the ability and the intent to keep the borrowings outstanding under the UNS Gas/UNS Electric Revolver for the next twelve months.

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**UED BORROWINGS**

In March 2009, UED entered into a 364-day, \$30 million senior secured term loan facility. The loan is guaranteed by UniSource Energy and is secured by a lien of substantially all the assets of UED, including the BMGS and an assignment of UED's PPA with UNS Electric. UED has the option of paying interest on the loan facility at LIBOR plus 3% or an alternative base rate plus 2%. The alternative base rate is the greater of federal funds plus 0.5%, the agent bank's reference rate or one-month LIBOR plus 1%. The terms of the facility require UED to make quarterly excess cash flow payments. UED paid \$1 million in debt issuance costs which are being amortized to interest expense over one year, the term of the loan. UED used the proceeds of the loan to pay a dividend of \$30 million to UniSource Energy. As of December 31, 2009, UED owed \$26 million under the senior secured term loan facility. In February 2010, UED amended its term loan facility 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. UED capitalized less than \$1 million in costs related to the transaction.

**DEBT MATURITIES**

Long-term debt, including term loan payments, revolving credit facilities classified as long-term, and capital lease obligations mature on the following dates:

	TEP Variable Rate IDBs Supported by Letters of Credit	TEP Scheduled Debt Retirements	TEP Capital Lease Obligations	TEP Total	UNS Gas	UNS Electric	UniSource Energy (includes UED)	Total
- Millions of Dollars -								
2010	\$ —	\$ —	\$ 93	\$ 93	\$ —	\$ —	\$ 32	\$ 125
2011	459	—	107	566	50	—	34	650
2012	—	—	118	118	—	—	—	118
2013	—	—	122	122	—	—	—	122
2014	—	—	195	195	—	—	—	195
Total 2010 — 2014	459	—	635	1,094	50	—	66	1,210
Thereafter	—	445	103	548	50	100	150	848
Less: Imputed Interest	—	—	(209)	(209)	—	—	—	(209)
<b>Total</b>	<b>\$ 459</b>	<b>\$ 445</b>	<b>\$ 529</b>	<b>\$1,433</b>	<b>\$ 100</b>	<b>\$ 100</b>	<b>\$ 216</b>	<b>\$1,849</b>

TEP's Variable Rate IDBs are backed by a \$341 million LOC issued pursuant to TEP's Credit Agreement which expires in August 2011 and TEP's \$132 million Letter of Credit Facility which was terminated in January 2010. Although the Variable Rate IDBs mature between 2018 and 2029, the above table reflects a redemption or repurchase of such bonds in 2011 as though the LOCs terminate without replacement upon expiration of the TEP Credit Agreement.

**NOTE 7. FAIR VALUE OF FINANCIAL INSTRUMENTS NOT CARRIED AT FAIR VALUE**

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

- The carrying amounts of our current assets and liabilities, including Current Maturities of Long-Term Debt, UED's term loan, and amounts outstanding under our credit agreements, approximate their fair value due to the short-term nature of these instruments. Accordingly, these items have been excluded from the table below.

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- Investments in Lease Debt and Equity: TEP calculated the present value of remaining cash flows at the balance sheet date using current market rates with similar characteristics with respect to credit rating and time-to-maturity. We also incorporated the impact of counterparty credit risk using market credit default swap data.
- Fixed Rate Long-Term Debt: UniSource Energy and TEP used quoted market prices, where available, or calculated the present value of remaining cash flows at the balance sheet date using current market rates for bonds with similar characteristics with respect to credit rating and time-to-maturity. We also incorporate the impact of our own credit risk using a credit default swap rate when determining the fair value of fixed rate long-term debt.
- Variable Rate Long-Term Debt: TEP considers the principal amounts of variable rate debt outstanding to be reasonable estimates of their fair value. The fair value of variable rate long-term debt has also been adjusted for credit risk using a credit default swap rate.

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

	December 31,			
	2009		2008	
	Carrying Value	Fair Value	Carrying Value	Fair Value
	-Millions of Dollars-			
<b>Assets:</b>				
TEP Investment in Lease Debt and Equity	\$ 132	\$ 140	\$ 127	\$ 144
Millennium Note Receivable	15	15	—	—
<b>Liabilities:</b>				
<b>Fixed Rate Long-Term Debt</b>				
TEP	445	336	445	322
UniSource Energy	795	693	795	661
<b>Variable Rate Long-Term Debt</b>				
TEP	459	452	459	441
UniSource Energy	459	452	459	441

See Note 6 for a description of TEP's investment in Springerville Lease Debt and Equity. TEP intends to hold the \$95 million investment in Springerville Lease Debt Securities to maturity (Springerville Coal Handling Facilities lease debt totaling \$7 million matures through July 1, 2011, and Springerville Unit 1 lease debt totaling \$88 million matures through January 1, 2013). This investment is stated at amortized cost, which means the purchase cost has been adjusted for the amortization of the premium and discount to maturity.

**NOTE 8. STOCKHOLDERS' EQUITY****DIVIDEND LIMITATIONS****UniSource Energy**

Our ability to pay cash dividends on Common Stock outstanding depends, in part, upon cash flows from our subsidiaries: TEP, UES, Millennium and UED, as well as compliance with various debt covenant requirements. As of December 31, 2009, we complied with the terms of all such debt covenant requirements. Because UNS and all of its subsidiaries are in compliance with their debt covenants at December 31, 2009, there are no amounts of net income which are restricted.

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In February 2010, UniSource Energy declared a first quarter dividend to shareholders of \$0.39 per share of UniSource Energy Common Stock. The dividend, totaling approximately \$14 million, will be paid on March 8, 2010 to common shareholders of record as of February 23, 2010. In 2009, UniSource Energy paid quarterly dividends to the shareholders of \$0.29 per share, for a total of \$1.16 per share, or \$41 million for the year. In 2008, UniSource Energy paid quarterly dividends to the shareholders of \$0.24 per share, for a total of \$0.96 per share, or \$34 million, for the year. During 2007, UniSource Energy paid quarterly dividends to the shareholders of \$0.225 per share, for a total of \$0.90 per share, or \$32 million, for the year.

In 2008, UniSource Energy's dividend to the shareholders of \$34 million exceeded its retained earnings. As a result, we recorded dividends of \$14 million against retained earnings and dividends of \$20 million against common stock. UniSource Energy has no additional paid-in capital. Such dividends do not represent a return of capital dividend for income tax purposes.

**TEP**

TEP paid dividends to UniSource Energy of \$60 million in 2009, \$3 million in 2008, and \$53 million in 2007. In 2009, TEP recorded \$0.8 million of dividend equivalents related to restricted stock units as dividends. UniSource Energy is the holder of TEP's common stock. TEP met the requirements discussed below before paying these dividends.

UniSource Energy contributed capital to TEP of \$30 million in 2009 and \$18 million in 2007.

Bank Credit Agreement

TEP's Credit Agreement as of August 2006 allows TEP to pay dividends as long as TEP complies with the agreement and certain financial covenants including quarterly limits on the ratio of total indebtedness to total earnings before interest expense/income, income taxes and non-cash items. TEP is in compliance with these covenants.

Federal Power Act

This Act states that dividends shall not be paid out of funds properly included in capital accounts. TEP's 2009, 2008 and 2007 dividends were paid from current year earnings.

**UNS Gas and UNS Electric**

The terms of the senior unsecured note agreements entered into by both UNS Gas and UNS Electric contain dividend restrictions. See Note 6. UES did not pay any dividends to UniSource Energy in 2009, 2008 or 2007.

UES made capital contributions to UNS Electric of less than \$0.5 million in 2008.

UniSource Energy made no capital contributions to UNS Electric in 2009 and 2008. UniSource Energy made capital contributions to UNS Electric of \$10 million in 2007.

**Millennium and UED**

Millennium paid dividends of \$4 million to UniSource Energy in January 2010, \$3 million in 2009, \$25 million in 2008 and \$15 million in 2007, all of which represented return of capital distributions.

UED paid dividends to UniSource Energy of \$9 million in February 2010, \$4 million of which represented return of capital distributions; \$30 million in 2009 which represented return of capital distributions; and \$0.5 million in 2008. Millennium and UED have no dividend restrictions.

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In December 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.

**NOTE 9. INCOME TAXES**

A reconciliation of the federal statutory income tax rate to each company's effective income tax rate is as follows:

	UniSource Energy				TEP	
	Years Ended December 31,					
	2009	2008	2007	2009	2008	2007
	-Millions of Dollars-					
Federal Income Tax Expense at Statutory Rate	\$ 59	\$ 11	\$ 34	\$ 51	\$ 5	\$ 31
State Income Tax Expense, Net of Federal Benefit	7	1	5	6	1	4
Depreciation Differences (Flow Through Basis)	1	2	3	1	2	3
San Juan Generating Station Environmental Penalties	—	3	—	—	3	—
Federal/State Tax Credits	(1)	(3)	(2)	(1)	(3)	(2)
Other	(2)	3	(1)	(2)	3	—
<b>Total Federal and State Income Tax Expense</b>	<b>\$ 64</b>	<b>\$ 17</b>	<b>\$ 39</b>	<b>\$ 55</b>	<b>\$ 11</b>	<b>\$ 36</b>
Effective Tax Rate	<b>38%</b>	<b>55%</b>	<b>40%</b>	<b>38%</b>	<b>71%</b>	<b>40%</b>

In 2008, it was determined that the environmental penalties at San Juan Generating Station 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.

Income tax expense included in the income statements consists of the following:

	UniSource Energy				TEP	
	Years Ended December 31,					
	2009	2008	2007	2009	2008	2007
	-Millions of Dollars-					
Current Tax Expense (Benefit)						
Federal	\$ 5	\$ (17)	\$ 14	\$ 7	\$ (12)	\$ 22
State	—	(2)	3	1	(1)	6
Total	5	(19)	17	8	(13)	28
Deferred Tax Expense (Benefit)						
Federal	48	34	20	38	23	9
State	11	2	2	9	1	(1)
Total	59	36	22	47	24	8
<b>Total Federal and State Income Tax Expense</b>	<b>\$ 64</b>	<b>\$ 17</b>	<b>\$ 39</b>	<b>\$ 55</b>	<b>\$ 11</b>	<b>\$ 36</b>

We record deferred income tax assets and liabilities for amounts that will result in tax deductions or taxable income on future tax returns. We consider it more likely than not that all the deferred tax assets will result in lower income taxes in the future. Consequently, we have not recorded a valuation allowance to reduce our deferred tax assets.



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The significant components of deferred income tax assets and liabilities consist of the following:

	UniSource Energy		TEP	
	December 31,		December 31,	
	2009	2008	2009	2008
	-Millions of Dollars-			
<b>Gross Deferred Income Tax Assets</b>				
Capital Lease Obligations	\$ 208	\$ 209	\$ 208	\$ 209
Customer Advances and Contributions in Aid of Construction	43	40	26	26
Alternative Minimum Tax Credit	43	49	28	35
Accrued Postretirement Benefits	24	24	24	24
Emission Allowance Inventory	13	13	12	12
Other	35	39	25	27
<b>Gross Deferred Income Tax Assets</b>	<b>366</b>	<b>374</b>	<b>323</b>	<b>333</b>
<b>Gross Deferred Income Tax Liabilities</b>				
Plant — Net	(442)	(390)	(397)	(357)
Capital Lease Assets — Net	(58)	(61)	(58)	(61)
Regulatory Asset — Income Taxes Recoverable Through Future Revenues	(7)	(8)	(7)	(8)
Pensions	(10)	(7)	(11)	(8)
Deferred Lease Payment	(5)	(6)	(5)	(6)
Other	(19)	(19)	(11)	(13)
<b>Gross Deferred Income Tax Liabilities</b>	<b>(541)</b>	<b>(491)</b>	<b>(489)</b>	<b>(453)</b>
<b>Net Deferred Income Tax Liabilities</b>	<b>\$ (175)</b>	<b>\$ (117)</b>	<b>\$ (166)</b>	<b>\$ (120)</b>

The balance sheets display the net deferred income tax liability as follows:

	UniSource Energy		TEP	
	December 31,		December 31,	
	2009	2008	2009	2008
	-Millions of Dollars-			
Deferred Income Taxes — Current Assets	\$ 52	\$ 61	\$ 51	\$ 60
Deferred Income Taxes — Noncurrent Liabilities	(227)	(178)	(217)	(180)
<b>Net Deferred Income Tax Liability</b>	<b>\$ (175)</b>	<b>\$ (117)</b>	<b>\$ (166)</b>	<b>\$ (120)</b>

Deferred Income Taxes — Current Assets at December 31, 2009 and 2008 for UniSource Energy includes \$3 million of deferred tax assets related to losses of a foreign investment held by a Millennium subsidiary. Management plans to dispose of its investment in the foreign joint venture and recognize the deferred losses on UniSource Energy's federal and state income tax returns. This recognition on filed tax returns will allow for realization of the deferred tax asset. If management is unable to complete its plans to dispose of the joint venture, UniSource Energy may be required to write off the deferred tax asset of \$3 million.

At December 31, 2008, UniSource Energy had \$43 million and TEP had \$28 million of state net operating loss carryforwards which are expected to be used on the 2009 income tax returns. Deferred tax assets also include \$2 million of federal and state capital loss carryforward at UniSource Energy which is also expected to be fully used on the 2009 income tax returns.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
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Management believes that based on its historical pattern of taxable income, UniSource Energy will produce sufficient income in the future to realize its deferred income tax assets. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or the entire deferred tax asset will not be realized. No valuation allowance has been recorded to reduce the balance in deferred tax assets since management believes it is more likely than not that UniSource Energy will be able to recognize the tax deductions on future returns.

The \$13 million income tax receivable at December 31, 2008 is attributable to a 2008 net operating loss which was carried back to prior years.

**Uncertain Tax Positions**

UniSource Energy and TEP adopted uncertain tax position accounting as of January 1, 2007. Accounting guidance requires us to determine whether it is “more likely than not” that we will sustain a tax position under examination. Each tax position is measured to determine the amount of benefit to recognize in the financial statements. The amount of unrecognized tax benefit reported by UniSource Energy, all of which is recorded at TEP, was \$19 million at December 31, 2009 and \$20 million at December 31, 2008. The following table shows the changes in unrecognized tax benefits of UniSource Energy and TEP:

	December 31,	
	2009	2008
<b>Unrecognized Tax Benefits, beginning of year</b>	<b>\$ 20</b>	<b>\$ 12</b>
Additions based on tax positions taken in the current year	1	6
Reductions based on settlements with tax authorities	(1)	—
Additions based on tax positions taken in the prior year	—	3
Reductions based on tax positions taken in the prior year	(1)	(1)
<b>Unrecognized Tax Benefits, end of year</b>	<b>\$ 19</b>	<b>\$ 20</b>

Unrecognized tax benefits which, if recognized, would reduce the effective tax rate, were \$1 million at December 31, 2009 and 2008 for both UniSource Energy and TEP.

The \$1 million decrease in the balance of unrecognized tax benefits from 2008 to 2009 relates to \$1 million of tax benefit attributable to tax positions taken in 2009 which may not be sustainable, offset by the recognition of \$1 million of tax benefits from prior years and recognition of \$1 million of tax benefits based on settlements with authorities. The balance in unrecognized tax benefits could increase in the next twelve months as a result of the ongoing IRS audits, but the amount of the increase cannot be determined.

TEP recognizes interest accrued related to unrecognized tax benefits in Other Interest Expense in the income statements. In 2009 \$1 million of interest expense was recorded and in 2008 no interest expense was recognized. The balance of interest payable at December 31, 2009 is \$2 million and at December 31, 2008 it was \$1 million. Penalties accrued are immaterial in amount.

UniSource Energy and TEP have been audited by the IRS through tax year 2004 and are currently under audit by the IRS for 2005, 2006, and 2008. Tax Year 2007 has not yet been selected for audit. The fieldwork for the 2005 and 2006 audits is complete and the audits are effectively settled. The 2005 and 2006 audits closed in January 2010. UniSource Energy and TEP have a current liability of \$2 million for taxes and interest to settle 2005 and 2006 audits. We are unable to determine when the 2008 audit will be completed. UniSource Energy and TEP are not currently under audit by any state tax agencies.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****NOTE 10. EMPLOYEE BENEFIT PLANS****PENSION BENEFIT PLANS**

TEP, UNS Gas and UNS Electric maintain noncontributory, defined benefit pension plans for substantially all regular employees and certain affiliate employees. Employees receive benefits based on their years of service and average compensation. TEP, UNS Gas and UNS Electric fund the plans by contributing at least the minimum amount required under Internal Revenue Service regulations.

We recognize the underfunded status of our defined benefit pension plans as a liability on our consolidated balance sheets. The underfunded status is measured as the difference between the fair value of the plans assets and the projected benefit obligation for pension plans. We recognize a regulatory asset to the extent these future costs are probable of recovery in rates. In December 2008, as a result of the 2008 TEP Rate Order, TEP reapplied regulatory accounting to its generation operations. Accordingly, TEP reclassified pension amounts related to its generation operations, previously recognized in AOCI, to a regulatory asset.

TEP also provides supplemental retirement benefits to certain employees whose benefits are limited by IRS benefit or compensation limitations. Changes in benefit obligations are recognized as a component of AOCI.

**Pension Contributions**

The Pension Protection Act of 2006 (The Pension Act) establishes minimum funding targets for pension plans beginning in 2008. A plan's funding target is the present value of all benefits accrued or earned as of the beginning of the plan year. While the annual targets are not legally required, if a plan does not meet the annual funding targets, the plan's benefit payment options are limited and a funding deficiency notice must be sent to all plan participants. All TEP, UNS Gas and UNS Electric plans are in compliance with The Pension Act.

UniSource Energy made pension plan contributions in 2009 of \$25 million, of which \$23 million was made by TEP.

In 2010, UniSource Energy expects to contribute \$22 million to the pension plans of which \$20 million will be made by TEP.

**TEP Salaried Employees Retirement Plan Amendment**

In August 2009, TEP amended one of its defined benefit pension plans to limit early retirement benefits for TEP non-union employees hired after June 1, 2009 and to modify disability retirement and survivor benefits for all TEP non-union employees. As a result of the pension plan amendment, the plan assets and liabilities were remeasured as of August 31, 2009. In performing the remeasurement, management reviewed the key assumptions used to measure the plan's benefit obligation at December 31, 2008 and to calculate pension expense for 2009. TEP determined that the discount rate should be increased to 6.40% from the 6.30% rate assumed at December 31, 2008. The revised discount rate was determined using the same methodology as was employed at year-end 2008. All other key assumptions, including the expected rate of return on assets, remained unchanged from December 31, 2008.

The amendment reduced the annual expense for 2009 for the salaried plan by less than \$1 million to \$8 million. The reduction in pension expense was recognized ratably from September to December of 2009. The remeasurement reduced the benefit obligation and corresponding regulatory asset by \$8 million.

In December 2009, TEP amended its defined benefit pension plan for union employees to limit early retirement benefits for TEP union employees hired on or after January 1, 2011, modify disability retirement and survivor benefits for TEP union employees, and modify maximum credited service beginning in 2009. Because the amendment was in December, there was no additional remeasurement.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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**OTHER POSTRETIREMENT BENEFIT PLANS**

TEP provides limited health care and life insurance benefits for retirees. All regular employees may become eligible for these benefits if they reach retirement age while working for TEP or an affiliate. UNS Gas and UNS Electric provide postretirement medical benefits for current retirees and a small group of active employees.

In the 2008 TEP Rate Order, the ACC authorized accrual basis recovery of other postretirement benefit plan costs based on a commitment to fund the plan. TEP established a Voluntary Employee Beneficiary Association (VEBA) trust in 2009 to fund its other postretirement benefit plan and began funding the plan. TEP, UNS Gas and UNS Electric now record changes in their other postretirement obligation, not yet reflected in net periodic benefit cost, as a regulatory asset, as such amounts are probable of future recovery in rates. Amounts previously recorded in AOCI were reclassified to a regulatory asset in 2008.

The pension and other postretirement benefit related amounts (excluding tax balances) included in the UniSource Energy balance sheet are:

	<u>Pension Benefits</u>		<u>Other Postretirement Benefits</u>	
	Years Ended December 31,			
	<u>2009</u>	<u>2008</u>	<u>2009</u>	<u>2008</u>
	-Millions of Dollars-			
Regulatory Pension Asset included in Other Regulatory Assets	\$ 75	\$ 105	\$ 9	\$ 7
Accrued Benefit Liability included in Accrued Employee Expenses	—	—	(4)	(4)
Accrued Benefit Liability included in Pension and Other Postretirement Benefits	(58)	(95)	(65)	(63)
Accumulated Other Comprehensive Loss	3	3	—	—
<b>Net Amount Recognized</b>	<b>\$ 20</b>	<b>\$ 13</b>	<b>\$ (60)</b>	<b>\$ (60)</b>

The table above includes accrued pension benefit liabilities for UNS Gas and UNS Electric of approximately \$5 million and \$7 million, at December 31, 2009 and 2008 respectively, and a postretirement benefit liability of \$1 million for UNS Gas and UNS Electric, for each period presented.

The balance remaining in AOCI of \$3 million relates to the TEP supplemental executive retirement plan.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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**OBLIGATIONS AND FUNDED STATUS**

We measured the actuarial present values of all pension benefit obligations and other postretirement benefit plans at December 31, 2009 and 2008. The tables below include TEP, UNS Gas and UNS Electric plans. The change in projected benefit obligation and plan assets and reconciliation of the funded status are as follows:

	Pension Benefits		Other Postretirement Benefits	
	Years Ended December 31,			
	2009	2008	2009	2008
	-Millions of Dollars-			
<b>Change in Projected Benefit Obligation</b>				
Benefit Obligation at Beginning of Year	\$ 230	\$ 209	\$ 67	\$ 65
Actuarial (Gain) Loss	—	13	1	—
Interest Cost	14	14	4	4
Service Cost	7	7	2	2
Measurement Date Change	—	1	—	—
Amendments	(1)	(2)	—	—
Benefits Paid	(8)	(12)	(3)	(4)
<b>Projected Benefit Obligation at End of Year</b>	<b>242</b>	<b>230</b>	<b>71</b>	<b>67</b>
<b>Change in Plan Assets</b>				
Fair Value of Plan Assets at Beginning of Year	135	193	—	—
Actual (Loss) Return on Plan Assets	32	(57)	—	—
Benefits Paid	(8)	(12)	(3)	(4)
Employer Contributions	25	10	5	4
Measurement Date Change	—	1	—	—
<b>Fair Value of Plan Assets at End of Year</b>	<b>184</b>	<b>135</b>	<b>2</b>	<b>—</b>
<b>Funded Status at End of Year</b>	<b>\$ (58)</b>	<b>\$ (95)</b>	<b>\$ (69)</b>	<b>\$ (67)</b>

The table above includes pension benefit obligations for UNS Gas and UNS Electric of approximately \$5 million and \$7 million, at December 31, 2009 and 2008, respectively, plan assets of \$6 million and \$4 million at December 31, 2009 and 2008, respectively, and a postretirement benefit liability of less than \$1 million, for UNS Gas and UNS Electric, for each period presented.

The following table provides the components of UniSource Energy's regulatory assets and accumulated other comprehensive loss that have not been recognized as components of net periodic benefit cost as of December 31, 2009:

	Pension Benefits		Other Postretirement Benefits	
	Years Ended December 31,			
	2009	2008	2009	2008
	-Millions of Dollars-			
Net Loss	\$ 77	\$ 105	\$ 13	\$ 13
Prior Service Cost (Benefit)	1	3	(4)	(6)

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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Information for pension plans with Accumulated Benefit Obligations in excess of plan assets follows:

	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
Projected Benefit Obligation at End of Year	\$ 242	\$ 230
Accumulated Benefit Obligation at End of Year	210	198
Fair Value of Plan Assets at End of Year	184	135

At December 31, 2008, and December 31, 2009, all UniSource Energy defined benefit pension plans had accumulated benefit obligations in excess of plan assets.

The components of net periodic benefit costs are as follows:

	<b>Pension Benefits</b>			<b>Other Postretirement Benefits</b>		
	Years Ended December 31,					
	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
	-Millions of Dollars-					
Service Cost	\$ 7	\$ 7	\$ 8	\$ 2	\$ 2	\$ 2
Interest Cost	14	14	13	4	4	4
Expected Return on Plan Assets	(11)	(16)	(14)	—	—	—
Prior Service Cost Amortization	1	2	1	(2)	(2)	(2)
Recognized Actuarial Loss	7	—	2	1	1	1
<b>Net Periodic Benefit Cost</b>	<b>\$ 18</b>	<b>\$ 7</b>	<b>\$ 10</b>	<b>\$ 5</b>	<b>\$ 5</b>	<b>\$ 5</b>

Approximately 20% of the net periodic benefit cost was capitalized as a cost of construction and the remainder was included in Other Operating and Maintenance costs.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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The changes in plan assets and benefit obligations recognized as regulatory assets or in AOCI are as follows:

	<b>Pension Benefits</b>					
	<b>2009</b>		<b>2008</b>		<b>2007</b>	
	<u>Regulatory Asset</u>	<u>AOCI</u>	<u>Regulatory Asset</u>	<u>AOCI</u>	<u>Regulatory Asset</u>	<u>AOCI</u>
	-Millions of Dollars-					
Current Year Actuarial (Gain) Loss	\$ (21)	\$ —	\$ 85	\$ 1	\$ (16)	\$ (6)
Amortization of Actuarial Gain (Loss)	(7)	—	—	—	(1)	(1)
Prior Service (Cost) Amortization	—	—	(2)	—	(1)	(1)
Plan Amendments	(1)	—	(2)	—	—	—
Reclassification from AOCI to Regulatory Asset	—	—	8	(8)	—	—
Change in Additional Minimum Liability	—	—	—	—	—	—
<b>Total Recognized</b>	<u>\$ (29)</u>	<u>\$ —</u>	<u>\$ 89</u>	<u>\$ (7)</u>	<u>\$ (18)</u>	<u>\$ (8)</u>

	<b>Other Postretirement Benefits</b>			
	<u>2009</u>	<u>2008</u>		<u>2007</u>
	<u>Regulatory Asset</u>	<u>Regulatory Asset</u>	<u>AOCI</u>	<u>AOCI</u>
	-Millions of Dollars-			
Current Year Actuarial (Gain) Loss	\$ 1	\$ —	\$ —	\$ (1)
Amortization of Actuarial Gain (Loss)	(1)	(1)	—	(1)
Prior Service (Cost) Amortization	2	2	—	2
Change in Additional Minimum Liability	—	—	—	(2)
Reclassification from AOCI to Regulatory Asset	—	6	(6)	—
<b>Total Recognized</b>	<u>\$ 2</u>	<u>\$ 7</u>	<u>\$ (6)</u>	<u>\$ (2)</u>

For all pension plans, we amortize prior service costs on a straight-line basis over the average remaining service period of employees expected to receive benefits under the plan. We will amortize \$5 million estimated net loss and less than \$1 million prior service cost from other regulatory assets or AOCI into net periodic benefit cost in 2010. The estimated net loss and prior service benefit for the defined benefit postretirement plans that will be amortized from other regulatory assets into net periodic benefit cost in 2010 are \$1 million and \$2 million, respectively.

UNISOURCE ENERGY, TEP AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFTAudit Committee  
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	Pension Benefits		Other Postretirement Benefits	
	2009	2008	2009	2008
<b>Weighted-Average Assumptions Used to Determine Benefit Obligations as of the Measurement Date</b>				
Discount Rate	6.3%	6.3%	6.0%	6.5%
Rate of Compensation Increase	3.0 – 5.0%	3.0 – 5.0%	N/A	N/A

	Pension Benefits			Other Postretirement Benefits	
	2009	2008	2007	2009	2008
<b>Weighted-Average Assumptions Used to Determine Net Periodic Benefit Cost for Years Ended December 31</b>					
Discount Rate	6.3%	6.6 – 6.8%	5.9%	6.5%	6.5%
Rate of Compensation Increase	3.0 – 5.0%	3.0 – 5.0%	3.0 – 5.0%	N/A	N/A
Expected Return on Plan Assets	8.0%	7.75 – 8.3%	8.3%	N/A	N/A

Net periodic benefit cost for the other postretirement benefit plan was remeasured as of January 1, 2007 to reflect the plan amendment communicated to plan participants on January 2, 2007. A discount rate of 5.6% was used for the January 2007 portion of the expense, while a discount rate of 5.8% was used for the remaining eleven months.

Net periodic benefit cost is subject to various assumptions and determinations, such as the discount rate, the rate of compensation increase, and the expected return on plan assets.

TEP, UNS Gas and UNS Electric use a combination of sources in selecting the expected long-term rate-of-return-on-assets assumption, including an investment return model. The model used provides a “best-estimate” range over 20 years from the 25<sup>th</sup> percentile to the 75<sup>th</sup> percentile. The model used as a guideline for selecting the overall rate-of-return-on-assets assumption is based on forward looking return expectations only. The above method is used for all asset classes.

Changes that may arise over time with regard to these assumptions and determinations will change amounts recorded in the future as net periodic benefit cost.

	December 31,	
	2009	2008
<b>Assumed Health Care Cost Trend Rates</b>		
Health Care Cost Trend Rate Assumed for Next Year	7.9%	7.5%
Ultimate Health Care Cost Trend Rate Assumed	4.5%	5%
Year that the Rate Reaches the Ultimate Trend Rate	2027	2017

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT**

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Assumed health care cost trend rates significantly affect the amounts reported for health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects on the December 31, 2009 amounts:

	<u>One-Percentage- Point Increase</u>	<u>One-Percentage- Point Decrease</u>
	-Millions of Dollars-	
Effect on Total of Service and Interest Cost Components	\$ 1	\$ (1)
Effect on Postretirement Benefit Obligation	5	(4)

**PENSION PLAN AND OTHER POSTRETIREMENT BENEFIT ASSETS**

TEP, UNS Gas and UNS Electric calculate the fair value of plan assets on December 31, the measurement date. The 2007 measurement date was December 1. Pension plan asset allocations, by asset category, were as follows:

<b>Asset Category</b>	<u>TEP Plan Assets</u>		<u>UNS Gas and UNS Electric Plan Assets</u>	
	<u>December 31, 2009</u>	<u>December 31, 2008</u>	<u>December 31, 2009</u>	<u>December 31, 2008</u>
Equity Securities	57%	51%	56%	67%
Fixed Income Securities	34%	33%	33%	31%
Real Estate	7%	13%	11%	—
Other	2%	3%	—	2%
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

UNISOURCE ENERGY, TEP AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFTAudit Committee  
2/19/10Fair Value Measurements of Pension Assets  
December 31, 2009  
(\$ in millions)

Asset Category	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Cash	\$ 1	\$ —	\$ —	\$ 1
Equity Securities:				
U.S. Large Cap	—	53	—	53
U.S. Small Cap	—	10	—	10
Non-U.S.	—	42	—	42
Fixed Income	—	63	—	63
Real Estate	—	5	8	13
Hedge Fund	—	—	1	1
Private Equity	—	—	1	1
Total	\$ 1	\$ 173	\$ 10	\$ 184

Level 1 cash equivalents are based on observable market prices and are comprised of the fair value of commercial paper, money market funds, and certificates of deposit.

Level 2 investments comprise amounts held in co-mingled equity funds, US bond and real estate funds. Valuations are based on active market quoted prices for assets held by each respective fund.

Level 3 real estate investments were valued by appraisal at September 30, 2009, and subsequently revalued at December 31, 2009. Revaluation comprised of using a preliminary real estate index value to estimate the percentage change in asset value from September 30, 2009, to December 31, 2009. The preliminary real estate index value was developed based on appraisals comprising 82% of real estate assets tracked by the index.

Level 3 hedge and private equity funds are classified as funds-of-funds. They are valued based on individual fund manager valuation models.

As of December 31, 2009, the fair value of VEBA trust assets were \$1.5 million of which \$1 million were fixed income investments and \$0.5 million were equities. There are no level three assets in the VEBA trust.

**A Reconciliation of Level 3 Assets follows:**

	Private Equity	Real Estate	Hedge Fund	Total
Beginning Balances at December 31, 2008	\$ 1	\$ 12	\$ 3	\$ 16
Actual Return on Plan Assets:				
Relating to Assets still held at Reporting Date	—	(4)	—	(4)
Relating to Assets sold during the Period	—	—	(1)	(1)
Purchases, Sales, and Settlements	—	—	(1)	(1)
Transfers in and/or out of Level 3	—	—	—	—
Ending Balance at December 31, 2009	\$ 1	\$ 8	\$ 1	\$ 10

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee  
2/19/10****Pension Plan Investments****Investment Goals**

Strategic asset allocation is the principal method for achieving each plan's investment objective, while maintaining an appropriate level of risk. We will consider the projected impact on benefit security of any proposed changes to the current asset allocation policy. The expected long-term returns and implications for Plan Sponsor funding will be reviewed in selecting policies to ensure that current asset pools are projected to be adequate to meet the expected liabilities of the Plans. We expect to use asset allocation policies weighted most heavily to equity and fixed income funds, while maintaining some exposure to real estate and opportunistic funds. Within the fixed income allocation, long-duration funds may be used to partially hedge interest rate risk. The plan seeks to provide returns in excess of a portfolio benchmark.

**Risk Management**

We recognize the difficulty of achieving investment objectives in light of the uncertainties and complexities of the investment markets. We also recognize some risk must be assumed to achieve a Plan's long-term investment objectives. In establishing risk tolerances, the following factors affecting risk tolerance and risk objectives will be considered: 1) Plan status; 2) Plan Sponsor financial status and profitability; 3) Plan features; and 4) workforce characteristics. We have determined that the Plans can tolerate some interim fluctuations in market value and rates of return in order to achieve long-term objectives. TEP tracks the plan's portfolio relative to the benchmark through quarterly investment reviews. The reviews consist of a performance and risk assessment of all investment managers and on the portfolio as a whole. Investment managers for the plan may use derivative financial instruments for risk management purposes or as part of their investment strategy. Currency hedges have also been used for defensive purposes.

**Relationship between Plan Assets and Benefit Obligations**

The overall health of the Plan will be monitored by comparing the value of Plan obligations (both Accumulated Benefit Obligation and Projected Benefit Obligation) against the market value of assets and tracking the changes in each. The frequency of this monitoring will depend on the availability of Plan data, but will be no less frequent than annually via annual actuarial valuation.

The current target allocation percentages for the major categories or plan assets follow. For each Plan, there is a range of +/- 2% of the target allocation before the fund will be automatically rebalanced. The hedge fund is being closed, and is currently in the redemption/liquidation process.

	<b>TEP Plan %</b>	<b>UES Plan %</b>	<b>VEBA Trust %</b>
Fixed Income	31.7%	33.4%	62.5%
U.S. Large Cap	26.4%	27.8%	27.6%
Non-US Developed	15.9%	16.7%	3.3%
Real Estate	10.6%	11.1%	—
U.S. Small Cap	5.2%	5.5%	1.6%
Non-US Emerging	5.2%	5.5%	—
Private Equity	5.0%	—	—
Cash / Treasury Bills	—	—	5.0%
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****Pension Fund Descriptions**

The funds are manager of manager funds, with the exception of the hedge fund and the private equity fund, which are funds of funds.

**ESTIMATED FUTURE BENEFIT PAYMENTS**

TEP expects the following benefit payments to be made by the defined benefit pension plans, which reflect future service, as appropriate.

	<b>Pension Benefits</b>	<b>Other Postretirement Benefits</b>
	-Millions of Dollars-	
2010	\$ 10	\$ 5
2011	11	5
2012	12	5
2013	13	6
2014	14	6
Years 2015-2019	88	30

UNS Gas and UNS Electric expect pension and postretirement benefit payouts of approximately \$4 million in 2010 through 2014 and \$7 million in 2015 through 2019 to be made by the defined benefit pension and postretirement plans.

**DEFINED CONTRIBUTION PLANS**

TEP, UNS Gas and UNS Electric offer defined contribution savings plans to all eligible employees. The Internal Revenue Code identifies the plans as qualified 401(k) plans. Participants direct the investment of contributions to certain funds in their account which may include a UNS stock fund. TEP, UNS Gas, and UNS Electric match part of a participant's contributions to the plans. TEP made matching contributions to these plans of approximately \$4 million in each of 2009, 2008, and 2007. UNS Gas and UNS Electric made matching contributions of less than \$0.5 million in each of 2009, 2008, and 2007.

**NOTE 11. SHARE-BASED COMPENSATION PLANS**

Under the 2006 Omnibus Stock and Incentive Plan, the Compensation Committee of the UniSource Energy Board of Directors may issue various types of share-based compensation, including stock options, restricted shares/units, and performance shares. The total number of shares which may be awarded under the Plan cannot exceed 2.25 million shares. At December 31, 2009, the total number of shares awarded under the 2006 Omnibus Stock and Incentive Plan was 1 million shares.

**STOCK OPTIONS**

In February 2009, the Compensation Committee of the UniSource Energy Board of Directors granted 248,760 stock options to officers with an exercise price of \$26.11. In 2008, the Compensation Committee of the UniSource Energy Board of Directors granted 303,550 stock options to officers with an exercise price of \$26.18. In 2007, the board granted 184,260 stock options to officers with an exercise price of \$37.88.

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Stock options are granted with an exercise price equal to the fair market value of the stock on the date of grant, vest over three years, become exercisable in one-third increments on each anniversary date of the grant and expire on the tenth anniversary of the grant. Compensation expense is recorded on a straight-line basis over the service period for the total award based on the grant date fair value of the options less estimated forfeitures. For awards granted to retirement eligible officers, compensation expense is recorded immediately. One stock option award accrues dividend equivalents that are paid in cash on the earlier of the date of exercise of the underlying option or the date the option expires. Dividend equivalents are recorded as dividends when declared. See discussion of dividend equivalents in Note 1.

The fair value of each option award was estimated on the date of grant using the Black-Scholes-Merton option pricing model with the assumptions noted in the following table. The expected terms of the stock options granted in 2009 and 2008 were estimated using historical exercise data. The expected term of 2007 options granted was estimated using a "simplified" method which considered the 3 year vesting period and the contractual term. The risk-free rate was based on the rate available on a U.S. Treasury Strip with a maturity equal to the expected term of the option at the time of the grant. The expected volatility for each award was based on historical volatility for UniSource Energy's stock for a period equal to the expected term of the award. The expected dividend yield on a share of stock was calculated using the historical dividend yield with the implicit assumption that current dividend yields will continue in the future.

	<b>2009</b>	<b>2008</b>	<b>2007</b>
Expected Term (years)	7	6	6
Risk-free Rate	3.4%	3.1%	4.4%
Expected Volatility	25.0%	18.8%	20.2%
Expected Dividend Yield	3.2%	2.8%	2.4%
Weighted-Average Grant-Date Fair Value of Options Granted During the Period	\$ 5.53	\$ 4.23	\$ 8.13

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A summary of the stock option activity follows:

(Shares in Thousands) <b>Stock Options</b>	<b>2009</b>		<b>2008</b>		<b>2007</b>	
	<b>Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Shares</b>	<b>Weighted Average Exercise Price</b>
Outstanding, Beginning of Year	1,635	\$ 22.50	1,451	\$ 21.21	1,388	\$ 18.59
Granted	249	\$ 26.11	304	\$ 26.18	184	\$ 37.88
Exercised or Vested	(282)	\$ 14.46	(120)	\$ 16.34	(120)	\$ 16.56
Forfeited/Expired	(4)	\$ 12.28	—	—	(1)	\$ 12.28
Outstanding, End of Year	<u>1,598</u>	<u>\$ 24.50</u>	<u>1,635</u>	<u>\$ 22.50</u>	<u>1,451</u>	<u>\$ 21.21</u>
Exercisable, End of Year	1,085	\$ 23.06	1,153	\$ 19.50	1,139	\$ 17.43
Aggregate Intrinsic Value of Options Exercised (\$000s)	\$ 4,177		\$ 1,680		\$ 2,226	

	At December 31, 2009(\$000s)	
Aggregate Intrinsic Value for Options Outstanding	\$	13,408
Aggregate Intrinsic Value for Options Exercisable	\$	10,679
Weighted Average Remaining Contractual Life of Outstanding Options		4.4 years
Weighted Average Remaining Contractual Life of Exercisable Options		3.0 years

A summary of stock options follows:

Range of Exercise Prices	<b>Options Outstanding</b>			<b>Options Exercisable</b>		
	<b>Number of Shares (000s)</b>	<b>Weighted- Average Remaining Contractual Life</b>	<b>Weighted- Average Exercise Price</b>	<b>Number of Shares (000s)</b>	<b>Weighted- Average Exercise Price</b>	
\$15.28 – \$18.84	664	1.6 years	\$ 17.39	664	\$ 17.39	
\$26.11 – \$37.88	934	6.4 years	\$ 29.55	421	\$ 31.99	

We summarize the status of non-vested stock options as of December 31, 2009, and changes during 2009 below:

<b>Non-vested Shares</b>	<b>Number of Shares (000s)</b>	<b>Weighted-Average Grant-Date Fair Value</b>
Non-vested at January 1, 2009	482	\$ 5.59
Granted	249	5.53
Vested	(218)	6.13
Forfeited	—	—
Non-vested at December 31, 2009	<u>513</u>	<u>\$ 5.33</u>

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****RESTRICTED STOCK UNITS/AWARDS AND PERFORMANCE SHARES****Restricted Stock Units**

Restricted stock and stock units are generally granted under the Plan to non-employee directors. Restricted stock is an award of Common Stock that is subject to forfeiture if the restrictions specified in the award are not satisfied. Stock units are a non-voting unit of measure that is equivalent to one share of Common Stock. The directors may elect to receive stock units in lieu of restricted stock. Restricted stock generally vests over periods ranging from one to three years and are payable in Common Stock. Stock units vest either immediately or over periods ranging from one to three years. The restricted stock units vest immediately upon death, disability, or retirement. In the January following the year the person is no longer a director, Common Stock shares will be issued for the vested stock units. Compensation expense equal to the fair market value on the grant date is recognized over the vesting period. Fully vested but undistributed stock unit awards accrue dividend equivalent stock units based on the fair market value of common shares on the date the dividend is paid.

The Compensation Committee of the UniSource Energy Board of Directors granted the following stock units to non-employee directors:

- May 2009 — 21,886 stock units at a weighted average fair value of \$26.73 per share,
- February 2008 — 3,130 stock units at a weighted average fair value of \$28.75 per share,
- May 2008 — 18,448 stock units at a weighted average fair value of \$31.71 per share,
- August 2008 — 1,400 stock units at a weighted average fair value of \$32.15 per share, and
- 2007 — 17,857 stock units at a weighted average fair value of \$37.30 per share.

**Performance Share Awards**

In February 2009, the Compensation Committee of the UniSource Energy Board of Directors granted 62,190 performance share awards (targeted shares) to Officers at a grant date fair value, based on a Monte Carlo simulation, of \$21.62 per share. The performance share awards will be paid out in shares of UniSource Energy common stock based on targeted, cumulative UniSource Energy Total Shareholder Return during the performance period of January 1, 2009 through December 31, 2011 compared with Total Shareholder Return over the same period of an industry peer group.

In February 2008, the Compensation Committee of the UniSource Energy Board of Directors granted 49,120 performance share awards (targeted shares) to Officers at a grant date fair value, based on a Monte Carlo simulation, of \$17.10 per share. The performance share awards will be paid out in shares of UniSource Energy Common Stock based on UniSource Energy's performance over the performance period of January 1, 2008 through December 31, 2010. The performance criteria specified in the awards is determined based on targeted UniSource Energy Total Shareholder Return during the performance period compared to the Total Shareholder Return over the same period of an industry or peer group. The performance shares vest based on goal attainment, upon completion of the performance period; any unearned awards are forfeited. Compensation expense equal to the fair value on the grant date is recognized over the vesting period if the requisite service period is fulfilled whether or not the threshold is achieved.

In March 2007, the Compensation Committee of the UniSource Energy Board of Directors granted 37,270 performance share awards (targeted shares) to certain officers at a grant date fair value of \$35.56 per share (market price of \$37.88 less the present value of expected dividends of \$2.32). At December 31, 2009, upon completion of the 3-year performance period, 22,116 shares vested based on achievement of targeted cumulative Cash Flows from Operations and cumulative Diluted Earnings per Share over the performance period; 15,154 shares were unearned and forfeited. Compensation expense equal to the fair market value on the grant date less the present value of expected dividends was recognized over the performance period and adjusted for goals that were not achieved. In February 2010, the Board of Directors approved distribution of the 22,116 vested shares of UniSource Energy Common Stock.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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	<u>Performance Shares</u>		<u>Restricted Stock Units</u>	
	<u>Shares (000s)</u>	<u>Weighted- Average Grant-Date Fair Value</u>	<u>Shares (000s)</u>	<u>Weighted- Average Grant-Date Fair Value</u>
Non-vested at January 1, 2009	67	\$ 25.23	23	\$ 31.33
Granted	62	21.62	22	26.73
Vested	(22)	35.56	(23)	31.33
Forfeited	(7)	35.56	—	—
Non-vested at December 31, 2009	<u>100</u>	<u>\$ 19.92</u>	<u>22</u>	<u>\$ 26.73</u>

**SHARE-BASED COMPENSATION EXPENSE (Stock Options, Performance Shares and Restricted Stock Units)**

Annually during 2007 through 2009, UniSource Energy and TEP recorded share-based compensation expense of \$3 million and \$2 million, respectively. The actual tax deduction realized from the exercise of share-based payment arrangements totaled \$3 million for 2009, \$1 million for 2008, and \$0.5 million in 2007. We capitalize approximately 30% of share-based compensation costs as a cost of construction.

At December 31, 2009, the total unrecognized compensation cost related to non-vested share-based compensation was \$2 million, which will be recorded as compensation expense over the remaining vesting periods through February 2011. The total number of shares awarded but not yet issued, including target performance based shares, under the share-based compensation plans at December 31, 2009 was 2 million.

**2010 SHARE-BASED COMPENSATION AWARDS**

In February 2010, the Compensation Committee of the UniSource Energy Board of Directors granted 93,720 performance share awards (targeted shares). 50% of the performance share awards will be paid out in shares of UniSource Energy Common Stock based on targeted, cumulative UniSource Energy Total Shareholder Return during the performance period of January 1, 2010 through December 31, 2012, compared to the Total Shareholder Return over the same period of an industry or peer group. The remaining 50% will be paid out in shares of UniSource Energy Common Stock based on cumulative net income for the 3-year period ended December 31, 2012. The performance shares vest based on goal attainment, upon completion of the performance period; any unearned awards are forfeited. Performance shares are eligible for dividend equivalents during the performance period.

**NOTE 12. FAIR VALUE MEASUREMENTS**

The following tables set forth, by level within the fair value hierarchy, UniSource Energy and TEP'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.

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	UniSource Energy			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	December 31, 2009 - Millions of Dollars -			
<b>Assets</b>				
Cash Equivalents <sup>(1)</sup>	\$ 51	\$ —	\$ —	\$ 51
Rabbi Trust Investments to support the Deferred Compensation and SERP Plans <sup>(2)</sup>	—	14	—	14
Equity Investments <sup>(3)</sup>	—	—	6	6
Collateral Posted <sup>(4)</sup>	—	2	—	2
Energy Contracts <sup>(5)</sup>	—	1	6	7
<b>Total Assets</b>	<b>51</b>	<b>17</b>	<b>12</b>	<b>80</b>
<b>Liabilities</b>				
Energy Contracts <sup>(5)</sup>	—	(16)	(19)	(35)
Interest Rate Swaps <sup>(6)</sup>	—	(6)	—	(6)
<b>Total Liabilities</b>	<b>—</b>	<b>(22)</b>	<b>(19)</b>	<b>(41)</b>
<b>Net Total Assets and (Liabilities)</b>	<b>\$ 51</b>	<b>\$ (5)</b>	<b>\$ (7)</b>	<b>\$ 39</b>

	UniSource Energy			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	December 31, 2008 - Millions of Dollars -			
<b>Assets</b>				
Cash Equivalents <sup>(1)</sup>	\$ 14	\$ —	\$ —	\$ 14
Rabbi Trust Investments to support the Deferred Compensation and SERP Plans <sup>(2)</sup>	—	9	—	9
Equity Investments <sup>(3)</sup>	—	—	11	11
Collateral Posted <sup>(4)</sup>	—	14	—	14
Energy Contracts <sup>(5)</sup>	—	1	6	7
<b>Total Assets</b>	<b>14</b>	<b>24</b>	<b>17</b>	<b>55</b>
<b>Liabilities</b>				
Energy Contracts <sup>(5)</sup>	—	(40)	(23)	(63)
Interest Rate Swaps <sup>(6)</sup>	—	(8)	—	(8)
<b>Total Liabilities</b>	<b>—</b>	<b>(48)</b>	<b>(23)</b>	<b>(71)</b>
<b>Net Total Assets and (Liabilities)</b>	<b>\$ 14</b>	<b>\$ (24)</b>	<b>\$ (6)</b>	<b>\$ (16)</b>

UNISOURCE ENERGY, TEP AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFTAudit Committee  
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	TEP			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	December 31, 2009 - 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>(5)</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>(5)</sup>	—	(5)	(9)	(14)
Interest Rate Swaps <sup>(6)</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>

	TEP			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
	December 31, 2008 - 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>	—	9	—	9
Energy Contracts <sup>(5)</sup>	—	—	10	10
<b>Total Assets</b>	<b>8</b>	<b>9</b>	<b>10</b>	<b>27</b>
<b>Liabilities</b>				
Energy Contracts <sup>(5)</sup>	—	(18)	(11)	(29)
Interest Rate Swaps <sup>(6)</sup>	—	(8)	—	(8)
<b>Total Liabilities</b>	<b>—</b>	<b>(26)</b>	<b>(11)</b>	<b>(37)</b>
<b>Net Total Assets and (Liabilities)</b>	<b>\$ 8</b>	<b>\$ (17)</b>	<b>\$ (1)</b>	<b>\$ (10)</b>

- (1) Cash Equivalents are based on observable market prices and are comprised of the fair value of commercial paper, 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) Equity Investments are, in the absence of readily ascertainable market values, based on the lower of the investment partners' valuations or management's valuation and comprise Millennium's equity investment in unregulated businesses. These investments are included in Investments and Other Property — Other in the UniSource Energy balance sheet.
- (4) Collateral provided for energy contracts with counterparties to reduce credit risk exposure.
- (5) 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.
- (6) Interest Rate Swaps are valued based on either the six-month LIBOR index or the Securities Industry and

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**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****Energy Contracts**

TEP, UNS Gas, and UNS Electric primarily apply the market approach for recurring fair value measurements and endeavor to utilize the best available information. Where observable inputs are available for substantially the full terms of the asset or liability, such as gas swap derivatives valued using New York Mercantile Exchange (NYMEX) pricing, adjusted for basin differences, the instrument is categorized in Level 2.

Derivatives valued using an aggregate pricing service or published prices that represent a consensus reporting of multiple brokers are categorized in Level 3. For both power and gas prices, TEP and UNS Electric obtain quotes from brokers, major market participants, exchanges or industry publications as well as its own price experience from active transactions in the market. TEP and UNS Electric primarily use 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. In addition, energy derivatives include 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 and UNS Electric apply 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. TEP and UNS Electric review these assumptions on a quarterly basis.

The fair value of TEP's and UNS Electric's purchase power call options is estimated using an internal pricing model which includes assumptions about market risks such as liquidity, volatility, and contract valuation. This model also considers credit and non-performance risk. UniSource Energy and TEP's assessment of the significance of a particular input to the fair value measurements requires judgment, and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT**

**Audit Committee**  
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The following tables set forth a reconciliation of changes in the fair value of financial assets and liabilities classified as Level 3 in the fair value hierarchy:

	Year Ended December 31, 2009 - Millions of Dollars -			
	UniSource Energy			TEP
	Mark-to- Market Contracts	Investments	Total	Mark-to- Market Contracts
<b>Balance, as of January 1, 2009</b>	\$ (17)	\$ 11	\$ (6)	\$ (1)
Gains and (Losses) (Realized/Unrealized)				
Recorded to:				
Net Regulatory Assets — Derivative Instruments	5	—	5	(2)
OCI	(1)	—	(1)	(1)
Other Expense	—	(2)	(2)	—
Cash — Proceeds from Sale of Investment	—	(3)	(3)	—
<b>Balance, as of December 31, 2009</b>	<u>\$ (13)</u>	<u>\$ 6</u>	<u>\$ (7)</u>	<u>\$ (4)</u>

Gains and losses on mark-to-market contracts include the reclassification of realized gains and losses on the settlement of derivative contracts. All of the Level 3 unrealized gains and losses are attributable to the change in fair value of Level 3 assets and liabilities held at the reporting date.

There were no transfers in or out of Level 3 derivatives.

**NOTE 13. UNISOURCE ENERGY EARNINGS PER SHARE (EPS)**

We compute basic EPS by dividing Net Income by the weighted average number of common shares outstanding during the period. Except when the effect would be anti-dilutive, the diluted EPS calculation includes the impact of shares that could be issued upon exercise of outstanding stock options, contingently issuable shares under equity-based awards or common shares that would result from the conversion of convertible notes. The numerator in calculating diluted earnings per share is Net Income adjusted for the interest on convertible notes (net of tax) that would not be paid if the notes were converted to common shares.

The following table shows the effects of potentially dilutive common stock on the weighted average number of shares:

	Years Ended December 31,		
	2009	2008	2007
	-In Thousands-		
<b>Numerator:</b>			
Net Income	\$ 104,258	\$ 14,021	\$ 58,373
Income from Assumed Conversion of Convertible Senior Notes	4,390	—	4,390
Adjusted Numerator	<u>\$ 108,648</u>	<u>\$ 14,021</u>	<u>\$ 62,763</u>
<b>Denominator:</b>			
Weighted-average Shares of Common Stock Outstanding			
Common Shares Issued	35,653	35,415	35,264
Fully Vested Deferred Stock Units	105	217	222
Participating Securities	100	—	—
Total Weighted-average Shares of Common Stock Outstanding and Participating Securities — Basic	<u>35,858</u>	<u>35,632</u>	<u>35,486</u>
Effect of Diluted Securities			
Convertible Senior Notes	4,093	—	4,000
Options and Stock Issuable under Employee Benefit Plans and the Directors' Plan	499	537	583
Total Shares	<u>40,450</u>	<u>36,169</u>	<u>40,069</u>



**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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For the year ended December 31, 2008, 4 million potentially dilutive shares from the conversion of convertible senior notes, and after-tax interest expense of \$4 million was not included in the computation of diluted EPS because to do so would be anti-dilutive.

Stock options to purchase an average of 395,000, 312,000 and 169,000 shares of Common Stock were outstanding during 2009, 2008 and 2007, respectively, but were not included in the computation of EPS because the stock option's exercise price was greater than the average market price of the Common Stock at year end.

**NOTE 14. RELATED PARTY TRANSACTIONS**

UniSource Energy incurs corporate costs that are allocated to its subsidiaries, including TEP. Corporate costs are allocated based on a weighted-average of three factors: assets, payroll and revenues. Management believes this method of allocation is reasonable and approximates the cost that TEP and its other affiliates would have incurred as stand-alone entities. Charges allocated to TEP were \$7 million in each of 2009, 2008 and 2007. Charges allocated to UNS Gas and UNS Electric were \$1 million in each of 2009, 2008 and 2007.

TEP provides all corporate services (finance, accounting, tax, information technology services, etc.) to UniSource Energy, UNS Gas and UNS Electric as well as to UniSource Energy's non-utility businesses. Costs are directly assigned to the benefiting entity where possible. Common costs are allocated on a cost-causative basis. Management believes this method of allocation is reasonable. The charges by TEP to the other companies were \$15 million in 2009 and 2008, and \$14 million in 2007.

TEP and UNS Electric began selling power to each other in 2008 at prices based on the Dow Jones Four Corners Daily Index. TEP had wholesale power sales to UNS Electric of \$23 million in 2009 and \$25 million in 2008. UNS Electric had wholesale power sales to TEP of \$4 million in 2009 and \$9 million in 2008.

TEP charged UNS Electric \$3 million for control area services in 2009 and \$2 million in 2008. No such services were provided in 2007.

In May 2008, UED began providing energy from its Black Mountain Generating Station (BMGS) to UNS Electric, through a power sale agreement. UED charged UNS Electric \$12 million in 2009 and \$7 million in 2008 for this energy. UNS Gas charged UNS Electric \$5 million for gas used by the BMGS facility in 2009 and \$7 million in 2008. In 2008, UNS Gas charged UED \$1 million for gas used by BMGS facility.

Southwest Energy Solutions, Inc. (SES), a subsidiary of Millennium, provides a supplemental workforce for TEP and UNS Electric. Types of services provided for TEP include dusk to dawn lighting, facilities maintenance, meter reading, transmission and distribution, line locating, fleet support, and general supplemental support. SES bills TEP for these services. Management believes that the charges for services are reasonable and approximate the cost that TEP would have incurred if it performed these services directly. SES charged TEP \$15 million in 2009, \$15 million in 2008 and \$14 million in 2007 for these services. SES provides meter reading services for UNS Electric. SES charged UNS Electric \$1 million for these services in 2009, 2008 and 2007.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****NOTE 15. SALE OF MILLENNIUM'S INVESTMENT IN SABINAS**

In June 2009, Millennium finalized a sale of its 50% equity interest in Carboelectrica Sabinas, S. de R.L. de C.V. (Sabinas), a Mexican limited liability company. Millennium received an upfront payment of \$5 million in January 2009 and a \$15 million, three-year, 6%, secured note receivable from Minerales de Monclova, S.A. de C.V. (Mimosa). Principal on the note is due at maturity; interest on the note is due annually on December 31. The \$15 million note is included in Investments and Other Property — Other on UniSource Energy's balance sheet. Millennium recorded a \$6 million pre-tax gain on the sale included in Other Income on UniSource Energy's income statement.

**NOTE 16. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

The following recently issued accounting standards are not yet reflected in the UniSource Energy and TEP's 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 qualitative and quantitative 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.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT**

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**NOTE 17. SUPPLEMENTAL CASH FLOW INFORMATION**

A reconciliation of net income to net cash flows from operating activities follows:

	<b>UniSource Energy</b>		
	Years Ended December 31,		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
	-Thousands of Dollars-		
<b>Net Income</b>	<b>\$ 104,258</b>	<b>\$ 14,021</b>	<b>\$ 58,373</b>
<b>Adjustments to Reconcile Net Income</b>			
<b>To Net Cash Flows from Operating Activities</b>			
Depreciation and Amortization Expense	176,018	147,690	140,638
Depreciation and Amortization Recorded to Fuel and Other O&M Expense	4,929	6,467	6,897
Amortization of Deferred Debt-Related Costs included in Interest Expense	4,171	3,891	3,831
Provision for Bad Debts	3,583	5,007	3,592
Deferred Income Taxes	58,692	35,739	22,021
California Power Exchange Provision for Wholesale Revenue Refunds	4,172	—	—
Pension and Postretirement Expense	23,594	11,991	14,442
Pension and Postretirement Funding	(30,078)	(13,928)	(13,809)
Gain on Sale of Millennium's Investment in Sabinas	(5,979)	—	—
Stock Based Compensation Expense	2,779	2,901	2,693
Excess Tax Benefit from Stock Options Exercised	(3,256)	(633)	(541)
Mark-to-Market Transactions	43	9,281	2,459
Impact of Reapplication of Regulatory Accounting	—	(40,144)	—
Provision for Navajo Retiree Health Care and Mine Reclamation	—	10,198	—
Amortization of Transition Recovery Asset	—	23,945	77,681
CTC Revenue Refunded	(12,141)	58,092	—
Over/Under Recovered Purchased Energy Cost	(17,091)	(10,337)	2,377
Decrease in Value of Millennium Investments	1,249	2,469	—
Net Unrealized Loss (Gain) on MEH Trading Activities	—	—	2,562
Changes in Assets and Liabilities which Provided (Used) Cash Exclusive of Changes Shown Separately			
Accounts Receivable	17,696	432	4,981
Collateral Posted	12,370	(14,120)	—
Materials and Fuel Inventory	(24,621)	(10,176)	(8,805)
Accounts Payable	(8,196)	8,164	(5,057)
Income Taxes	14,924	(12,720)	(2,895)
Interest Accrued	15,956	16,772	10,031
Other Regulatory Liabilities	10,009	7,501	2,903
Taxes Other Than Income Taxes	(48)	(29)	1,344
Other	(5,723)	14,537	(2,952)
<b>Net Cash Flows — Operating Activities</b>	<b>\$ 347,310</b>	<b>\$ 277,011</b>	<b>\$ 322,766</b>

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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	TEP		
	Years Ended December 31,		
	2009	2008	2007
	-Thousands of Dollars-		
<b>Net Income</b>	<b>\$ 89,248</b>	<b>\$ 4,363</b>	<b>\$ 53,456</b>
<b>Adjustments to Reconcile Net Income</b>			
<b>To Net Cash Flows from Operating Activities</b>			
Depreciation and Amortization Expense	152,901	126,040	119,811
Depreciation and Amortization Recorded to Fuel and Other O&M Expense	3,439	5,039	5,339
Amortization of Deferred Debt-Related Costs included in Interest Expense	2,364	2,826	2,677
Provision for Bad Debts	2,342	2,957	2,161
California Power Exchange Provision for Wholesale Revenue Refunds	4,172	—	—
Deferred Income Taxes	46,721	24,410	8,310
Pension and Postretirement Expense	21,294	10,402	12,683
Pension and Postretirement Funding	(28,330)	(12,439)	(12,479)
Stock Based Compensation Expense	2,121	2,239	2,097
CTC Revenue Refunded	(12,141)	58,092	—
Over/Under Recovered Purchased Energy Cost	(20,724)	—	—
Mark-to-Market Transactions	44	9,283	2,459
Impact of Reapplication of regulatory accounting	—	(40,144)	—
Provision for Navajo Retiree Health Care and Mine Reclamation	—	10,198	—
Amortization of Transition Recovery Asset	—	23,945	77,681
<b>Changes in Assets and Liabilities which Provided (Used)</b>			
<b>Cash Exclusive of Changes Shown Separately</b>			
Accounts Receivable	9,488	131	4,013
Materials and Fuel Inventory	(23,794)	(8,774)	(9,103)
Accounts Payable	(10,410)	14,812	(6,230)
Income Taxes	(2,057)	10,127	(3,378)
Interest Accrued	16,142	15,857	10,113
Taxes Other Than Income Taxes	725	(1,011)	1,463
Other Regulatory Liabilities	10,555	6,449	—
Other	3,964	3,904	(6,961)
<b>Net Cash Flows — Operating Activities</b>	<b>\$ 268,064</b>	<b>\$ 268,706</b>	<b>\$ 264,112</b>

UED prepaid \$2 million for its LIBOR borrowing with Union Bank on July 28 and again on October 30, 2009 in accordance with the terms of the UED Credit Agreement. In August and November 2009, the deposits were applied to the \$30 million principal giving rise to a \$4 million non-cash financing activity that affected recognized assets and liabilities but did not result in cash receipts or payments.

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, Arizona Pollution Control Bonds. TEP had no cash receipts or payments as a result of this transaction.

In the third quarter of 2008, TEP deposited the Pima B redemption proceeds for its 7.5% collateral trust bonds with a trustee. On August 1, 2008, the deposit was applied to the payment of \$128 million of principal plus \$5 million of accrued interest upon maturity of the bonds giving rise to a \$128 million non-cash financing activity that affected recognized assets and liabilities but did not result in cash receipts or payments.



**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
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Other non-cash investing and financing activities of UniSource Energy and TEP that affected recognized assets and liabilities but did not result in cash receipts or payments were as follows:

	Years Ended December 31,		
	2009	2008	2007
	-Thousands of Dollars-		
(Decrease)/Increase to Utility Plant Accruals	\$ 1,082	\$ (25,450)	\$ 24,915
Net Cost of Removal of Interim Retirements	43,381	45,100	21,301
Capital Lease Obligations	17,984	16,612	13,259

The non-cash additions to Utility Plant represent accruals for capital expenditures.

The non-cash net cost of removal of interim retirements represents an accrual for future asset retirement obligations that does not impact earnings.

The non-cash change in capital lease obligations represents interest accrued for accounting purposes in excess of interest payments.

**NOTE 18. ACCOUNTING FOR DERIVATIVE INSTRUMENTS, TRADING ACTIVITIES AND HEDGING ACTIVITIES**

See Note 1 for description of our related accounting policies.

**Financial Impact of Derivatives**

The net unrealized gains and losses on these contracts reported in AOCI were as follows:

	UniSource Energy and TEP		
	2009	2008	2007
	-Millions of Dollars-		
<b>Cash Flow Hedges — Unrealized Gains (Losses)</b>			
Forward Power Contracts	\$ (1)	\$ (7)	\$ —
Gas Price Swaps	—	3	(5)
Interest Rate Swaps	1	(5)	(1)
<b>Total Pre-Tax Unrealized Gains (Losses)</b>	<u>\$ —</u>	<u>\$ (9)</u>	<u>\$ (6)</u>
<b>After-Tax Unrealized Gains (Losses) Recorded in AOCI</b>	<u>\$ —</u>	<u>\$ (5)</u>	<u>\$ (4)</u>
<b>After-Tax Unrealized (Gains) Losses Reclassified to Net Income</b>	<u>\$ 1</u>	<u>\$ 2</u>	<u>\$ 2</u>

**Regulatory Treatment of Commodity Derivatives**

Prior to December 2008, unrealized gains and losses resulting from changes in the market prices of non-trading hedges or short-term forward power sales contracts were recorded on the same line in the income statement as the hedged transaction. 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.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
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UniSource Energy and TEP report unrealized gains and losses on energy contracts that are recoverable through the PPFAC or PGA on the balance sheet as a regulatory asset or a regulatory liability rather than as a component of AOCI or in the income statement. UniSource Energy recorded decreases to regulatory balances of \$29 million and increases of \$65 million in 2009 and 2008, respectively. In 2007, UniSource Energy recorded an increase to regulatory balances of \$6 million. TEP recorded decreases to regulatory balances of \$11 million and increases of \$19 million in 2009 and 2008, respectively. Realized gains and losses on settled gas swaps are fully recovered through the PPFAC or PGA. In 2009, 2008, and 2007, UniSource Energy realized losses of \$51 million, \$9 million and \$9 million, respectively. TEP realized losses of \$29 million, \$4 million and \$9 million in 2009, 2008, and 2007, respectively.

At December 31, 2009, TEP had contracts that will settle through the third quarter of 2015; UNS Electric had contracts that will settle through the fourth quarter of 2013; and UNS Gas had contracts that will settle through the fourth quarter of 2012.

**Other Commodity Derivatives**

UniSource Energy and TEP record unrealized gains and losses on energy trading contracts in Wholesale Sales. In 2009, 2008, and 2007, net unrealized gains and losses were less than \$0.5 million.

**Derivative Volumes**

At December 31, 2009, UniSource Energy and TEP had gas swaps totaling 13,321GBtu and 5,658 GBtu, respectively, and power contracts totaling 3,859 GWh and 1,247 GWh, respectively, which were accounted for as derivatives.

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

	<u>2009</u>	<u>2008</u>	<u>2007</u>
	-Millions of Dollars-		
Recorded in Wholesale Sales:			
Forward Power Sales	\$ 23	\$ 30	\$ 28
Forward Purchased Power	(21)	(30)	(28)
<b>Net Impact in Wholesale Sales</b>	<u>\$ 2</u>	<u>\$ —</u>	<u>\$ —</u>

**Credit Risk Adjustment**

When the fair value of our derivative contracts are reflected as an asset, the counterparty owes us and this creates credit risk. We minimize our credit risk by (1) entering into transactions with high-quality counterparties; (2) limiting our exposure to each counterparty; (3) monitoring the financial condition of the counterparties; and (4) requiring collateral in accordance with the counterparty master agreements. Using a combination of market credit default swap data and historical recovery rates for subordinated bonds, we consider the impact of counterparty credit worthiness in determining the fair value of our derivatives as well as its possible effect on continued qualification for cash flow hedge accounting. At December 31, 2009, and December 31, 2008, the impact of counterparty credit risk on the fair value of derivative asset contracts was less than \$0.5 million.

We also consider the impact of our own credit risk on instruments that are in a net liability position, after deducting collateral posted, using market credit default swap data and allocating the credit risk adjustment to all individual contracts in a net liability position. At December 31, 2009, and December 31, 2008, the impact of our own credit risk was less than \$0.5 million.

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued) — DRAFT****Audit Committee**  
**2/19/10****CONCENTRATION OF CREDIT RISK**

The use of contractual arrangements to manage the risks associated with changes in energy commodity prices creates credit risk exposure resulting from the possibility of nonperformance by counterparties pursuant to the terms of their contractual obligations. TEP, UNS Gas and UNS Electric enter into contracts for the physical delivery of energy and gas which contain remedies in the event of non-performance by the supply counterparties. In addition, volatile energy prices can create significant credit exposure from energy market receivables and mark-to-market valuations.

TEP, UNS Gas and UNS Electric have contractual agreements for their energy procurement and hedging activities that contain certain provisions that require each company to post collateral under certain circumstances. These circumstances include credit rating downgrades, or a failure to meet certain financial ratios. In the event that such credit events were to occur, TEP, UNS Gas and UNS Electric would have to provide certain credit enhancements in the form of cash or letters of credit to fully collateralize their exposure to these counterparties.

The following table shows the sum of the fair value of all derivative instruments along with net payable position under contracts with credit-risk-related contingent features that are in a net liability position at December 31, 2009. It also shows cash collateral and letters of credit posted, and additional collateral to be posted if credit-risk related contingent features were triggered.

	<u>TEP</u>	<u>UNS Gas</u>	<u>UNS Electric</u>	<u>UniSource Energy</u>
	December 31, 2009			
	-Millions of Dollars-			
Net Liability Position	\$ 26	\$ 25	\$ 20	\$ 71
Cash Collateral Posted	—	2	—	2
Letters of Credit	1	—	11	12
Additional Collateral to Post if Contingent Features Triggered	26	23	14	63

As of December 31, 2009, TEP had \$20 million of credit exposure to other counterparties' creditworthiness related to its wholesale marketing and gas hedging activities, of which four counterparties individually composed greater than 10% of the total credit exposure. At December 31, 2009, UNS Gas and UNS Electric had immaterial exposure to other counterparties.

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**2/19/10****NOTE 19. QUARTERLY FINANCIAL DATA (UNAUDITED)**

Our quarterly financial information is unaudited but, in management's opinion, includes all adjustments necessary for a fair presentation. Our utility businesses are seasonal in nature. Peak sales periods for TEP and UNS Electric generally occur during the summer months and peak sales periods for UNS Gas generally occur during the winter months. Accordingly, comparisons among quarters of a year may not represent overall trends and changes in operations.

	<b>UniSource Energy</b>			
	<u>First</u>	<u>Second</u>	<u>Third</u>	<u>Fourth</u>
	-Thousands of Dollars- (except per share data)			
<b>2009</b>				
Operating Revenue	\$ 311,857	\$ 337,784	\$ 414,239	\$ 330,544
Operating Income	33,300	59,090	116,858	43,085
Net Income	4,919	31,275	57,646	10,418
Basic EPS	0.14	0.88	1.60	0.29
Diluted EPS	0.14	0.80	1.45	0.28
<b>2008</b>				
Operating Revenue	\$ 330,134	\$ 360,322	\$ 387,852	\$ 319,203
Operating Income	22,017	34,627	13,900	69,899
Net Income (Loss)	(2,614)	4,747	(11,039)	22,927
Basic EPS	(0.07)	0.13	(0.31)	0.64
Diluted EPS	(0.07)	0.13	(0.31)	0.60

EPS is computed independently for each of the quarters presented. Therefore, the sum of the quarterly EPS amounts may not equal the total for the year.

	<b>TEP</b>			
	<u>First</u>	<u>Second</u>	<u>Third</u>	<u>Fourth</u>
	-Thousands of Dollars-			
<b>2009</b>				
Operating Revenue	\$ 213,274	\$ 271,544	\$ 357,189	\$ 254,704
Operating Income	18,572	51,594	108,055	31,902
Net Income (Loss)	(553)	26,507	55,277	8,017
<b>2008</b>				
Operating Revenue	\$ 228,602	\$ 294,141	\$ 323,312	\$ 233,198
Operating Income	7,460	29,752	6,329	58,969
Net Income (Loss)	(8,862)	5,765	(12,237)	19,697

**UNISOURCE ENERGY, TEP AND SUBSIDIARIES**  
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The principal unusual items for TEP and UniSource Energy include:

**UniSource Energy and TEP**

- **Fourth Quarter 2009.** In December 2009, based on settlement discussions related to its sales to the CPX and CISO, TEP wrote off the remaining receivable balance of \$2 million and accrued an additional liability of \$2 million resulting in a \$4 million (\$2.4 million after-tax) reduction in net income.
- **Fourth Quarter 2008.** In the fourth quarter of 2008, as a result of the 2008 TEP Rate Order, TEP reapplied regulatory accounting to its generation operations, and consequently, recorded a reduction to fuel expense, O&M and Taxes Other Than Income Taxes of \$32 million, \$1 million and \$7 million, respectively. The total after-tax impact on net income was an increase of \$24 million.
- **Third Quarter 2008.** In the third quarter of 2008, as a result of a settlement between Peabody and the Navajo Generating Station participants, TEP recorded, as fuel expense, the present value of its share of the Navajo Generating Station mine reclamation and postretirement benefit costs, totaling \$9 million (\$5 million after-tax).

**UniSource Energy**

- **Second Quarter 2009.** Millennium recorded a \$6 million (\$3.6 million after-tax) gain on the sale of its Sabinas investment.