**FORM 51-102F4**
**BUSINESS ACQUISITION REPORT**

## ITEM 1 IDENTITY OF COMPANY

### 1.1 Name and Address of Company

Fortis Inc. ("Fortis" or the "Corporation")
Suite 1201, 139 Water Street
St. John's, Newfoundland and Labrador A1B 3T2

### 1.2 Executive Officer

The following senior officer of Fortis is knowledgeable about the significant acquisition and this report:

Karl W. Smith
Executive Vice President, Chief Financial Officer
(709) 737-2822

## ITEM 2 DETAILS OF ACQUISITION

### 2.1 Nature of Business Acquired

UNS Energy Corporation ("UNS Energy") is a utility services holding company headquartered in Tucson, Arizona engaged through its subsidiaries in the regulated electric generation and energy delivery business, primarily in the State of Arizona. UNS Energy's fiscal 2013 operating revenues totalled approximately US$1.5 billion and, as at June 30, 2014, UNS Energy had total assets of approximately US$4.5 billion.

UNS Energy has three regulated utility subsidiaries: Tucson Electric Power Company ("TEP"), UNS Electric, Inc. ("UNS Electric") and UNS Gas, Inc. ("UNS Gas") (collectively, the "UNS Utilities"). UNS Energy's utility operations are vertically integrated with generation, transmission and distribution being regulated by both the Arizona Corporation Commission ("ACC") and the US Federal Energy Regulatory Commission ("FERC").

TEP is a vertically integrated regulated electric utility and is UNS Energy's largest and principal operating subsidiary, representing approximately 85% of the total assets as at June 30, 2014 and approximately 79% of the operating revenues of UNS Energy for the six months ended June 30, 2014. TEP was incorporated in the State of Arizona in 1963 and currently generates, transmits and distributes electricity to approximately 414,000 retail electric customers in southern Arizona. TEP's service territory covers 1,155 square miles (2,991 square kilometres) and includes a population of approximately 1,000,000 people in the greater Tucson metropolitan area in Pima County, as well as parts of Cochise County. TEP also sells electricity to other entities in the western United States.

UNS Electric is a vertically integrated regulated electric utility company serving approximately 93,000 retail customers in Arizona's Mohave and Santa Cruz counties. These counties have a combined population of approximately 250,000. UNS Electric represented approximately 9% of the total assets of UNS Energy as at June 30, 2014 and approximately 12% of the operating revenues of UNS Energy for the six months ended June 30, 2014.

UNS Gas is a regulated gas distribution company serving approximately 150,000 retail customers in Arizona's Mohave, Yavapai, Coconino, Navajo and Santa Cruz counties. These counties, with a combined population of approximately 700,000, comprise approximately 50% of the territory in the State of Arizona. UNS Gas represented approximately 6% of the total assets of UNS Energy as at June 30, 2014 and approximately 9% of the operating revenues of UNS Energy for the six months ended June 30, 2014.

The non-regulated business of UNS Energy, which comprises less than 1% of UNS Energy's total assets, includes the operations of Millennium Energy Holdings, Inc. ("Millennium") and UniSource Energy Development Company ("UED"). Southwest Energy Solutions, Inc. ("SES"), a wholly owned subsidiary of Millennium, provides electrical contracting and meter reading services in Arizona, as well as other services at the Springerville Generating Station ("Springerville").

A detailed description of the business of UNS Energy is set out in Schedule A hereto.

## 2.2 Date of Acquisition

Fortis completed the Acquisition (as defined below) of all of the issued and outstanding shares of UNS Energy on August 15, 2014.

## 2.3 Consideration

On August 15, 2014, Fortis completed the acquisition (the "Acquisition") of all of the issued and outstanding shares of UNS Energy for aggregate consideration of approximately US$4.5 billion, comprised of approximately US$2.5 billion of cash (the "Cash Purchase Price") and the assumption of approximately US$2.0 billion of debt on closing.

Fortis financed a significant portion of the Cash Purchase Price for the Acquisition by drawing (i) $2.0 billion from its acquisition credit facilities, consisting of a $1.7 billion short-term bridge facility, repayable in full nine months following its advance, and a $300 million medium-term bridge facility (together, the "Acquisition Credit Facilities"), repayable in full on the second anniversary of its advance and (ii) US$265 million under its $1.0 billion committed revolving corporate credit facility (the "Revolving Facility"). The remainder of the Cash Purchase Price was financed through available cash on hand. A significant portion of this outstanding indebtedness will be repaid with the net proceeds from the final instalment payable by October 27, 2014 (the "Final Instalment Date") in an aggregate amount of $1.165 billion (the "Net Final Instalment Proceeds") on the Corporation's 4.00% convertible unsecured subordinated debentures (the "Convertible Debentures") represented by instalment receipts. On or after the Final Instalment Date, holders of fully paid Convertible Debentures are entitled to convert their Convertible Debentures into common shares ("Common Shares") of Fortis at a conversion price of $30.72 per Common Share, being a conversion rate of 32.5521 Common Shares per $1,000 principal amount of Convertible Debentures.

In furtherance of the receipt of regulatory approvals required in connection with the Acquisition, Fortis has committed to provide UNS Energy's customers and community with certain benefits, including but not limited to: (i) providing the retail consumers of the UNS Utilities with bill credits totalling US$30 million over five years (US$10 million in year one and US$5 million annually in years two through five); (ii) UNS Energy and the UNS Utilities adopting certain ring-fencing and corporate governance provisions, including UNS Energy establishing a board of directors comprised of a majority of independent members, as well as a majority of Arizona residents; (iii) limiting dividends paid from the UNS Utilities to UNS Energy to 60% of the UNS Utilities' respective net income for a period of five years following completion of the Acquisition or until such time that their respective equity capitalization reaches 50% of total capital (excluding any goodwill recorded) as accounted for in accordance with accounting principles generally accepted in the United States; and (iv) Fortis making an equity infusion totalling US$220 million through UNS Energy into the UNS Utilities after the closing of the Acquisition.

## 2.4 Effect on Financial Position

Fortis does not have any current plans for material changes in its business affairs or the affairs of UNS Energy which may have a significant effect on the results of operations and financial position of Fortis.

## 2.5 Prior Valuations

Not applicable.

**2.6 Parties to Transaction**

The Acquisition was not a transaction with an informed person, associate or affiliate of Fortis (as such terms are defined in National Instrument 51-102 – *Continuous Disclosure Obligations*).

**2.7 Date of Report**

September 2, 2014.

**ITEM 3 FINANCIAL STATEMENTS**

The following financial statements are included as schedules to this Business Acquisition Report:

**Schedule B**

Audited consolidated financial statements of UNS Energy and TEP as at December 31, 2013 and December 31, 2012, together with the Reports of Independent Registered Public Accounting Firm on such consolidated financial statements dated February 25, 2014, except for the effects of the revision discussed in Note 1 to the consolidated financial statements, as to which the date is August 14, 2014.

**Schedule C**

Unaudited interim consolidated financial statements of UNS Energy and TEP for the three and six months ended June 30, 2014.

**Schedule D**

Unaudited *pro forma* consolidated financial statements of Fortis as at and for the six months ended June 30, 2014 and for the year ended December 31, 2013.

**Caution Regarding Unaudited Pro Forma Consolidated Financial Statements**

This Business Acquisition Report contains the unaudited *pro forma* consolidated balance sheet as at June 30, 2014 and consolidated statements of earnings of the Corporation as at and for the six months ended June 30, 2014 and for the year ended December 31, 2013, giving effect to: (i) the Acquisition; and (ii) assumptions related to the financing of the Acquisition, including drawings under the Acquisition Credit Facilities, the Revolving Facility, the receipt of the Net Final Instalment Proceeds and the issuance of up to 58,593,750 Common Shares upon the conversion of the Convertible Debentures. Such unaudited *pro forma* consolidated financial statements have been prepared using certain of the Corporation's and UNS Energy's respective financial statements as more particularly described in the notes to such unaudited *pro forma* consolidated financial statements. Such unaudited *pro forma* consolidated financial statements are not intended to be indicative of the results that would actually have occurred, or the results expected in future periods, had the events reflected herein occurred on the dates indicated. Actual amounts recorded upon the finalization of the purchase price allocation under the Acquisition may differ from such unaudited *pro forma* consolidated financial statements. Since the unaudited *pro forma* consolidated financial statements have been developed to retroactively show the effect of a transaction that occurred at a later date (even though this was accomplished by following generally accepted practice using reasonable assumptions), there are limitations inherent in the very nature of *pro forma* data. The data contained in the unaudited *pro forma* consolidated financial statements represents only a simulation of the potential impact of the Acquisition. Undue reliance should not be placed on such unaudited *pro forma* consolidated financial statements.

In this Business Acquisition Report, unless otherwise specified or the context otherwise requires, all dollar amounts are expressed in Canadian dollars. References to "dollars", "$" or "Cdn$" are to lawful currency of Canada. References to "US Dollars" or "US$" are to lawful currency of the United States of America, sometimes referred to herein as the "US"). On August 29, 2014, the noon buying rate as reported by the Bank of Canada was US$1.00 = Cdn$1.0858.

DATED this 2nd day of September, 2014.

by *(signed) Karl W. Smith*

Karl W. Smith
Executive Vice President, Chief Financial Officer

## SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Business Acquisition Report contains forward-looking information which reflects management's expectations regarding (i) the future growth, results of operations, performance, and business prospects and opportunities of the Corporation, (ii) the future performance, business prospects and opportunities of UNS Energy and the integration of its electric and gas utility businesses with the existing operations of Fortis and (iii) the impact of the transactions entered into by the Corporation in connection with the financing of the Acquisition, including drawings under the Acquisition Credit Facilities and the Revolving Facility, the receipt of the Net Final Instalment Proceeds and the issuance of up to 58,593,750 Common Shares upon the conversion of the Convertible Debentures. These expectations may not be appropriate for other purposes. All forward-looking information is given pursuant to the "safe harbour" provisions of applicable Canadian securities legislation. The words "anticipates", "believes", "budgets", "could", "estimates", "expects", "forecasts", "intends", "may", "might", "plans", "projects", "schedule", "should", "will", "would" and similar expressions are often intended to identify forward-looking information, although not all forward-looking information contains these identifying words. Although the forward-looking information reflects management's current beliefs and is based on information currently available to management, there can be no assurance that actual results will be consistent with the forward-looking information. The forward-looking information is subject to significant risks, uncertainties, assumptions and other factors that could cause actual results to differ materially from historical results or results anticipated by the forward-looking information. A number of factors could cause actual results, performance or achievements to differ materially from the results discussed or implied in the forward-looking information. These factors should be considered carefully and undue reliance should not be placed on the forward-looking information. All forward-looking information is provided as of the date of this Business Acquisition Report and qualified in its entirety by the above cautionary statements. Except as required by law, the Corporation undertakes no obligation to revise or update any forward-looking information as a result of new information, future events or otherwise.

## SCHEDULE A
## THE BUSINESS OF UNS ENERGY

**UNS Energy Corporation**

UNS Energy is a utility services holding company headquartered in Tucson, Arizona engaged through its subsidiaries in the regulated electric generation and energy delivery business, primarily in the State of Arizona.

UNS Energy has three regulated utility subsidiaries, TEP, UNS Electric and UNS Gas. The percentage of UNS Energy's total assets, operating revenues and net income by regulated utility subsidiary as at and for the six months ended June 30, 2014 was as follows:

**Percentage of UNS Energy**
**(As at and for the Six Months Ended June 30, 2014)**

| Subsidiary | Total Assets | Operating Revenues | Net Income |
|---|---|---|---|
| TEP | 85% | 79% | 82% |
| UNS Electric | 9% | 12% | 10% |
| UNS Gas | 6% | 9% | 8% |

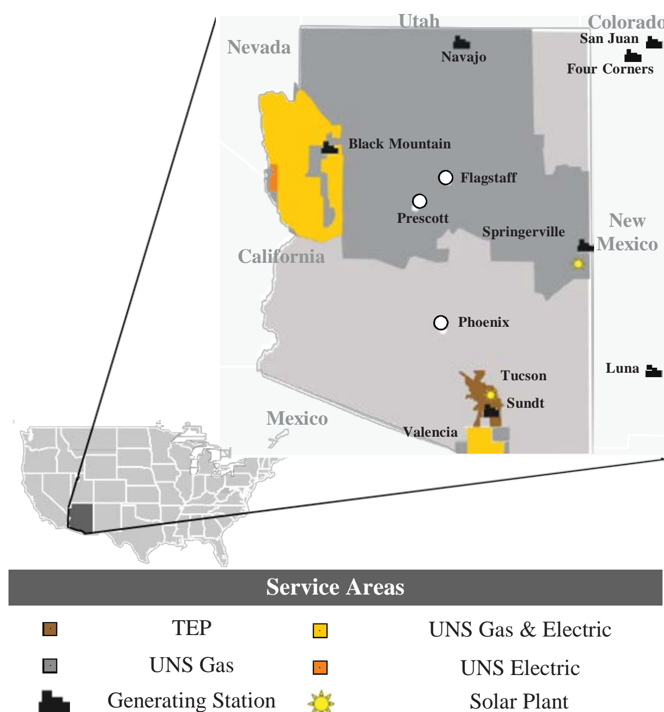
Revenues of each of TEP and UNS Electric include revenues from retail electricity sales and wholesale electricity sales made primarily from power generated at facilities owned or leased by TEP or UNS Electric, as applicable. In addition, TEP receives income from its transmission assets and its operation of Springerville Units 3 and 4 for Tri-State Generation and Transmission Association, Inc. ("Tri-State") and Salt River Project Agricultural Improvement and Power District ("SRP"), respectively. UNS Gas' revenues primarily arise from retail and wholesale gas sales.

For information on the financial condition and results of UNS Energy, reference is made to the audited consolidated financial statements of UNS Energy as of December 31, 2013 and 2012, including the consolidated statements of income and cash flows for each of the years ended December 31, 2013, 2012 and 2011, and the unaudited consolidated financial statements of UNS Energy for the three and six months ended June 30, 2014, each of which is included in this Business Acquisition Report.

**UNS Energy Service Territory**

UNS Energy's regulated utility subsidiaries service approximately 657,000 retail customers in Arizona. The following map depicts the service territories and generating stations of UNS Energy and its regulated utility subsidiaries.

**UNS Energy Utility Service Areas**




## UNS Energy Generation Profile

UNS Energy currently owns or leases generation resources with an aggregate capacity of 2,392 megawatts ("MW"), including 18 MW of solar capacity. At June 30, 2014, approximately 70% of UNS Energy's generating capacity is fueled by coal. The aggregate generating capacity of Arizona's utilities is approximately 15,500 MW, 34% of which is fueled by coal.

## TEP

TEP is a vertically integrated, regulated electric utility and UNS Energy's largest and principal operating subsidiary, representing approximately 85% of the total assets as at June 30, 2014 and approximately 79% of the operating revenues of UNS Energy for the six months ended June 30, 2014. TEP was incorporated in the State of Arizona in 1963 and currently generates, transmits and distributes electricity to approximately 414,000 retail electric customers in southern Arizona. TEP's service territory covers 1,155 square miles (2,991 square kilometres) and includes a population of approximately 1,000,000 people in the greater Tucson metropolitan area in Pima County, as well as parts of Cochise County. TEP has sufficient generating capacity which, together with existing power purchase agreements and expected generation plant additions, should satisfy the requirements of its customer base and meet expected future peak demand requirements. In addition, TEP sells electricity to other entities in the western United States.

### *Peak Demand*

Peak demand occurs during the summer months due to the cooling requirements of TEP's retail customers. Retail peak demand varies from year-to-year due to weather, economic conditions, and other factors. TEP's retail peak demand declined over the period of 2009 to 2013 due primarily to weak economic conditions and the implementation of energy efficiency programs. TEP experienced a retail peak demand of 2,230 MW in 2013. TEP believes its existing generation capacity, together with power purchase agreements and expected generation plant additions will be sufficient to meet future demand.

### *Retail Customers*

TEP provides electric utility service to a diverse group of residential, commercial, industrial and public sector customers. Retail sales accounted for 78% of TEP's operating revenues in 2013. In 2013, 42% of TEP's energy sales were to residential customers, 23% were to commercial customers, 23% were to non-mining industrial customers and 12% were to mining customers. In 2014, the retail energy consumption by customer class is expected to be similar to the historical customer distribution. Major industries served include copper mining, cement manufacturing, defense, health care, education, military bases and other governmental entities. Two of TEP's largest single customers are in the copper mining industry. Sales to these two customers decreased by 1.2% in 2013 due in part to a higher occurrence of planned and unplanned maintenance at the mines that reduced the mines' demand for electricity. TEP's retail sales are influenced by several factors, including economic conditions, seasonal weather patterns, demand side management ("DSM") initiatives and the increasing use of energy efficient products, and opportunities for customers to generate their own electricity.

Local, regional and national economic factors have impacted the growth in the number of customers in TEP's service territory. In 2013, 2012 and 2011, TEP's average number of retail customers increased by less than 1% year over year. During the past three years, economic conditions in the State of Arizona and state requirements for energy efficiency and distributed generation have negatively affected TEP's retail electricity sales. TEP's retail sales volumes in 2013 were approximately 9,279 gigawatt-hours ("GWh") or 0.1% below 2010 sales volumes.

### *Wholesale Customers*

TEP's electric utility operations include the wholesale marketing of electricity to other utilities and power marketers in the southwestern United States. Wholesale sales transactions are made on both a firm and interruptible basis and accounted for 11% of TEP's total 2013 operating revenues. A firm contract requires TEP to supply power on demand (except under limited emergency circumstances), while an interruptible contract allows TEP to stop supplying power in specific circumstances. See "TEP — Generating and Other Resources".

Generally, TEP commits to future sales to third parties based on expected excess generating capability, forward prices and generation costs, using a diversified portfolio approach to provide a balance between long-term, mid-term and spot energy sales. TEP's wholesale sales consist primarily of long-term or short-term sales.

Long-Term Sales

Long-term wholesale sales contracts cover periods of more than one year. TEP typically uses its own generation to serve the requirements of its long-term wholesale customers. In 2013, 20% of TEP's wholesale revenues, or approximately 2% of TEP's total 2013 operating revenues, were attributable to long-term wholesale sales contracts. TEP's material long-term wholesale power supply contracts are described below:

- Through May 2016, SRP is required to purchase 500,000 megawatt-hours ("MWh") of on-peak energy per year from TEP.
- TEP has a contract with the Navajo Tribal Utility Authority ("NTUA") which expires in December 2022. TEP serves the portion of NTUA's load that is not served by the authority's allocation of federal hydroelectric power. Over the last three years, sales to NTUA averaged 225,000 MWh per year.

Short-Term Sales

Short-term forward contracts commit TEP to sell a specified amount of capacity or energy at a specified price over a given period of time, typically for one-month, three-month or one-year periods. TEP also engages in short-term sales by selling energy in the daily or hourly markets at fluctuating spot market prices and making other non-firm energy sales. In 2013, 69% of TEP's operating revenues from wholesale sales, or approximately 8% of TEP's total 2013 operating revenues, were attributable to short-term sales. All revenues from short-term wholesale sales offset fuel and purchased power costs and are passed through to TEP's retail customers. TEP uses short-term wholesale sales as part of its hedging strategy to reduce customer exposure to fluctuating power prices. In addition, 10% of profits from short-term wholesale sales activity is passed through to TEP's retail customers.

*Generating and Other Resources*

At June 30, 2014, TEP owned electrical generating capacity of 1,853 MW and leased electrical generating capacity of 387 MW, for total net generating capacity of 2,240 MW, as set forth in the table below. Several of the generating assets in which TEP has an interest are jointly owned. In the United States, large power generation facilities are often developed by partnerships or joint ventures of different utilities to assist with financing the large capital expenditures required in connection with the construction of such facilities. See "Risk Factors Relating to the Post-Acquisition Business and Operations of the Corporation and UNS Energy — Jointly-owned generating plants and generating plants operated by third parties".

**TEP Sources of Net Generating Capacity**

| Generating Source | Unit No. | Location | Date In Service | Resource Type | Net Capability MW | Operating Agent | TEP's % | Share MW |
|---|---|---|---|---|---|---|---|---|
| Springerville Station [(1)] | 1 | Springerville, AZ | 1985 | Coal | 387 | TEP | 100.0 | 387 |
| Springerville Station | 2 | Springerville, AZ | 1990 | Coal | 390 | TEP | 100.0 | 390 |
| Springerville Station [(2)] | 3 | Springerville, AZ | 2005 | Coal | 400 | TEP | 0.0 | 0 |
| Springerville Station [(2)] | 4 | Springerville, AZ | 2009 | Coal | 400 | TEP | 0.0 | 0 |
| San Juan Station | 1 | Farmington, NM | 1976 | Coal | 340 | PNM | 50.0 | 170 |
| San Juan Station | 2 | Farmington, NM | 1973 | Coal | 340 | PNM | 50.0 | 170 |
| Navajo Station | 1 | Page, AZ | 1974 | Coal | 750 | SRP | 7.5 | 56 |
| Navajo Station | 2 | Page, AZ | 1975 | Coal | 750 | SRP | 7.5 | 56 |
| Navajo Station | 3 | Page, AZ | 1976 | Coal | 750 | SRP | 7.5 | 56 |
| Four Corners Station | 4 | Farmington, NM | 1969 | Coal | 784 | APS | 7.0 | 55 |
| Four Corners Station | 5 | Farmington, NM | 1970 | Coal | 784 | APS | 7.0 | 55 |
| Luna Generating Station | 1 | Deming, NM | 2006 | Gas | 555 | PNM | 33.3 | 185 |
| Sundt Station | 1 | Tucson, AZ | 1958 | Gas/Oil | 81 | TEP | 100.0 | 81 |
| Sundt Station | 2 | Tucson, AZ | 1960 | Gas/Oil | 81 | TEP | 100.0 | 81 |
| Sundt Station | 3 | Tucson, AZ | 1962 | Gas/Oil | 104 | TEP | 100.0 | 104 |
| Sundt Station | 4 | Tucson, AZ | 1967 | Coal/Gas | 156 | TEP | 100.0 | 156 |
| Sundt Internal Combustion Turbines | | Tucson, AZ | 1972-1973 | Gas/Oil | 50 | TEP | 100.0 | 50 |
| DeMoss Petrie | | Tucson, AZ | 1972 | Gas/Oil | 75 | TEP | 100.0 | 75 |
| North Loop | | Tucson, AZ | 2001 | Gas | 95 | TEP | 100.0 | 95 |
| Springerville Solar Station | | Springerville, AZ | 2002-2010 | Solar | 6 | TEP | 100.0 | 6 |
| Tucson Solar Projects | | Tucson, AZ | 2010-2012 | Solar | 12 | TEP | 100.0 | 12 |
| Total TEP Capacity [(3)] | | | | | | | | 2,240 |

(1) 14.1% owned and 85.9% of generating capacity under lease as of December 31, 2013. As of January 2015 the capacity received by TEP from Springerville Unit 1 will be reduced to 49.5% of its continuous operating capability. See "TEP — Generating and Other Resources — Springerville Generating Station".

(2) Springerville Units 3 and 4 are operated by TEP, but are owned by Tri-State and SRP, respectively. These facilities are located at the same site as Springerville Units 1 and 2. The owners of Springerville Units 3 and 4 compensate TEP for operating the facilities and pay an allocated portion of the fixed costs related to the Springerville Common Facilities and the Springerville Coal Handling Facilities. TEP is not entitled to any net generating capacity from Springerville Units 3 and 4.

(3) Excludes 683 MW of additional resources, which consist of certain capacity purchases and interruptible retail load.

Springerville Generating Station

TEP currently owns a 14.1% undivided interest in Unit 1 of the coal-fired Springerville and leases the remaining 85.9%. Springerville Unit 2 is owned by San Carlos Resources, Inc. ("San Carlos"), a wholly owned subsidiary of TEP. Springerville Units 3 and 4 are owned by Tri-State and SRP, respectively. TEP operates all four Springerville generating units, and Tri-State and SPR compensate TEP for operating the facilities. TEP is not entitled to any net generating capacity from Springerville Units 3 and 4.

TEP's other interests in Springerville include leasehold interests in the Springerville Coal Handling Facilities and the facilities at Springerville used in common by all four Springerville units ("Springerville Common Facilities"). In 1984, TEP sold and leased back the Springerville Coal Handling Facilities and has since purchased a 13% ownership interest therein. In April 2014, TEP committed to the purchase of the Springerville Coal Handling Facilities at the fixed price of US$120 million upon the expiration of the lease term in April 2015. Upon such purchase, SRP will be obligated to buy a portion of the Springerville Common Facilities and Tri-State will be obligated to either buy a portion of the Springerville Common Facilities or continue making payments to TEP for the use of its facilities.

TEP's lease arrangement relating to Springerville Unit 1 and an undivided one-half interest in certain Springerville Common Facilities ("Springerville Unit 1 Leases"), expire in 2015 but contain optional fair market value renewal and purchase provisions. In 2013, TEP exercised purchase options with respect to an additional aggregate 35.4% undivided interest in Springerville Unit 1 from the owner participants at an aggregate purchase price of approximately US$66 million, with the closing of the lease purchase options scheduled to occur in December 2014 and January 2015. In 2015, following TEP's acquisition of the additional 35.4% interest in Springerville Unit 1 and the expiry of the Springerville Unit 1 Leases, TEP's share of the continuous operating capability of Springerville Unit 1 will be reduced to 49.5%. TEP has indicated that it does not intend to acquire an ownership interest in Springerville Unit 1 that is greater than 50% due to its intention to reduce its exposure to coal generation.

TEP's lease arrangements relating to an undivided one-half interest in certain Springerville Common Facilities ("Springerville Common Facilities Leases"), which expire in 2017 and 2021, have optional fair market value renewal options as well as a fixed-price purchase provision. The fixed prices to acquire the interest in the Springerville Common Facilities currently leased by TEP are US$38 million in 2017 and US$68 million in 2021.

Sundt Station and Sundt Internal Combustion Turbines

TEP owns and operates the Sundt Internal Combustion Turbines and all four units of the Sundt Generating Station (the "Sundt Station") located near Tucson, Arizona. The Sundt Internal Combustion Turbines have a net generating capacity of 50 MW. Sundt Station Units 1, 2 and 3 can be operated on either natural gas or diesel oil and have a net generating capacity of 81 MW, 81 MW and 104 MW, respectively. Sundt Station Unit 4 can be operated on either natural gas or coal and has a net generating capacity of 156 MW. The Sundt Station and the Sundt Internal Combustion Turbines are designated as "must-run generation" facilities. Must-run generation units are required to run in certain circumstances to maintain distribution system reliability and to meet local load requirements. See "Environmental Regulation — Regional Haze Rules — Sundt".

Purchases and Interconnections

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

TEP typically uses generation from its gas-fired units, in addition to energy from its coal-fired facilities and purchased power, to meet the summer peak demands of its retail customers and local reliability needs. Some of these power purchase agreements ("PPAs") are price-indexed to natural gas prices. Due to its increasingly seasonal gas and purchased power usage, TEP hedges a portion of its total natural gas exposure with fixed price contracts for a maximum of three years. TEP also purchases energy in the daily and hourly markets to meet higher than anticipated demands, to cover unplanned generation outages or when doing so is more economical than running owned generation. These costs are primarily recovered from customers through retail rates.

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

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

Renewable Energy Resources

As of June 30, 2014, TEP owned 18 MW of photovoltaic ("PV") solar generating capacity. The Springerville solar system, which is located near Springerville, has a total capacity of 6 MW. TEP's remaining 12 MW of PV solar generating capacity is located in the City of Tucson. In 2014, TEP expects to complete solar projects providing capacity of 20 MW at Ft. Huachuca, Arizona and 10 MW in Springerville, Arizona.

In order to meet the ACC's renewable energy requirements which, among other things, require TEP, UNS Electric and other affected utilities to increase their use of renewable energy each year until it represents at least 15% of their total annual retail energy requirements in 2025, TEP has PPAs for 124 MW of capacity from solar resources, 102 MW of capacity from wind resources and 4 MW of capacity from a landfill gas generation plant. As of December 31, 2013, approximately 88 MW of solar resources and 51 MW of wind resources contracted by TEP were operational. The remaining resources contracted by TEP are expected to be developed over the next several years. The solar PPAs contain options that would allow TEP to purchase all or part of the related project at a future period. See "Regulation — Renewable Energy Standard and Tariff".

Future Generating Resources

TEP is evaluating several energy resource options, including coal, natural gas and renewables for future use to satisfy its power requirements. The focus of TEP's long-term energy resource diversification strategy is to provide long-term rate stability for customers, mitigate environmental impacts, comply with regulatory requirements and leverage existing utility infrastructure. TEP is gradually reducing its reliance on coal generation over time by increasing the capacity of efficient combined-cycle gas turbines and renewables, particularly by adding solar generating capacity, and expects coal to represent less than 50% of generating capacity by the year 2020. TEP will add generating resources and/or transmission import capability to meet forecasted retail and firm wholesale load demands. TEP's ACC approved 2014 Renewable Energy Standard ("RES") implementation plan includes an investment of US$28 million for company-owned solar projects and an additional US$12 million in 2015.

In December 2013, TEP and UNS Electric entered into an agreement (the "Gila River Purchase Agreement") with a subsidiary of Entegra Power Group LLC ("Entegra") to purchase Unit 3 of the Gila River Generating Station ("Gila River") in Gila Bend, Arizona. Gila River is a natural gas-fired combined-cycle unit with a capacity rating of 550 MW, which went into service in 2003. It is anticipated that TEP will purchase a 75% undivided interest in Gila River Unit 3 (413 MW) for approximately US$164 million and UNS Electric expects to purchase the remaining 25% undivided interest (137 MW) for approximately US$55 million, although TEP and UNS Electric may modify the percentage ownership allocation between them. The purchase of Gila River is consistent with TEP's strategy to diversify its generation fuel mix and gradually reduce its reliance on coal. See "TEP — Fuel Supply". The purchase of Gila River is expected to close in December 2014, subject to, among other things, receipt of required regulatory approvals. Entegra filed a prepackaged Chapter 11 bankruptcy in the U.S. Bankruptcy Court for the District of Delaware on August 4, 2014. TEP and UNS Electric anticipated the bankruptcy filing and do not expect it to impact their purchase of Gila River Unit 3. TEP expects to finance the anticipated acquisition of Gila River using equity injections from Fortis and, in turn, UNS Energy and the issuance of long-term debt.

Gila River will replace foregone coal-fired leased capacity following expiry of the Springerville Unit 1 Leases and the expected reduction of coal-fired generating capacity from San Juan Unit 2, which may be retired on or before December 31, 2017. See "Environmental Regulation — Regional Haze Rules — San Juan".

***Fuel Supply***

TEP's fuel cost and usage information for the three most recently completed calendar years are:

| | **Average Cost per kWh (US cents per kWh)** | | | **Percentage of Total kWh Resources** | | |
|---|---|---|---|---|---|---|
| | **2013** | **2012** | **2011** | **2013** | **2012** | **2011** |
| Coal | 2.66 | 2.54 | 2.56 | 75% | 72% | 73% |
| Gas | 4.57 | 4.54 | 5.99 | 8% | 11% | 7% |
| Purchased Power | 4.83 | 3.44 | 3.94 | 17% | 17% | 20% |
| All Sources | 3.54 | 3.19 | 3.30 | 100% | 100% | 100% |

Coal

TEP's principal fuel for electric generation is low-sulfur, bituminous or sub-bituminous coal from mines in Arizona, New Mexico and Colorado. In 2013, 75% of TEP's total energy resources were supplied by TEP's coal generation, compared to 72% in 2012 and 73% in 2011. In 2013, 91% of the total power generated by TEP was generated from coal. More than 90% of TEP's coal supply is purchased under long-term contracts, which results in more predictable prices. TEP's average cost per tonne of coal, including transportation, was US$48.51 in 2013, US$45.84 in 2012 and US$46.64 in 2011. The following table sets forth the supplier, contract expiration date and amount of coal consumed in 2013 for TEP's coal generating stations, under which coal was purchased under a long-term supply contract:

| **Generating Station** | **Coal Supplier** | **2013 Coal Consumption** | **Contract Expiration** |
|---|---|---|---|
| Springerville | Peabody Coalsales | 3,172 | 2020 |
| Four Corners | BHP Billiton | 381 | 2016 |
| San Juan | San Juan Coal Co. | 1,306 | 2017 |
| Navajo | Peabody Coalsales | 560 | 2019 |

TEP is currently the operator and sole owner (or lessee) of the Springerville Units 1 and 2 (see "TEP — Generating and Other Resources — Springerville Generating Station") and Sundt Unit 4 coal-fired generation plants. The coal supplies for Springerville Units 1 and 2 are transported approximately 200 miles by railroad from northwestern New Mexico. TEP expects its contracted coal reserves to be sufficient to supply the estimated requirements for Springerville Units 1 and 2 for their presently estimated remaining lives.

The coal supplies for Sundt Unit 4 are transported approximately 1,300 miles by railroad from Colorado. Prior to 2010, Sundt Unit 4 was predominantly fueled by coal; however, the generating station can also be operated using natural gas. Both fuels are combined with methane, a renewable energy resource, piped in from a nearby landfill. Since 2010, TEP has fueled Sundt Unit 4 with both coal and natural gas depending on which resource is most economic. In 2014, TEP expects to fuel Sundt Unit 4 primarily with existing coal supplies at the site. TEP does not expect to encounter any issues in sourcing coal for use in Sundt Unit 4 in the future, to the extent that coal is used as the fuel for this generator.

TEP also participates in jointly-owned coal-fired generating facilities at the Four Corners Generating Station ("Four Corners"), the Navajo Generating Station ("Navajo") and the San Juan Generating Station ("San Juan"). Four Corners, which is operated by Arizona Public Service ("APS") and San Juan, which is operated by Public Service Company of New Mexico ("PNM") are mine-mouth generating stations located adjacent to the coal reserves used in those generating plants. Navajo, which is operated by SRP, obtains its coal supply from a nearby coal mine with a dedicated rail delivery system. The coal supplies used at Four Corners, Navajo and San Juan are under long-term contracts administered by the operating agents. TEP expects coal reserves available to these three jointly-owned generating facilities to be sufficient for the remaining presently estimated lives of the generating stations. See also "Environmental Regulation — Regional Haze Rules" and "Risk Factors Relating to the Post-Acquisition Business and Operations of the Corporation and UNS Energy".

Natural Gas Supply

TEP typically uses generation from its gas-fired units, in addition to energy from its coal-fired facilities and purchased power, to meet the summer peak demands of its retail customers and local reliability needs. TEP purchases gas from Southwest Gas Corporation under a retail tariff for its North Loop generating station's 95 MW of internal combustion turbines and receives distribution service under a transportation agreement for its DeMoss Petrie generating station, a 75 MW internal combustion turbine. TEP purchases capacity from El Paso Natural Gas ("EPNG") for transportation from the San Juan and Permian Basins to its Sundt plant under a contract effective through 2018. TEP also buys gas from third-party suppliers for the Sundt and DeMoss Petrie generating stations.

TEP purchases gas transportation for the Luna Generating Station ("Luna") from EPNG from the Permian Basin to the plant site under an agreement effective through January 2017, with a right-of-first-refusal for continuation thereafter. TEP purchases gas for its share of Luna from various suppliers in the Permian Basin region.

***Transmission Access***

TEP has transmission access and power transaction arrangements with over 140 electric systems or suppliers. TEP also has various ongoing projects that are designed to increase access to the regional wholesale energy market and improve the reliability, capacity and efficiency of its existing transmission and distribution systems. In 2013, approximately 1% of TEP's operating revenue was derived from TEP's wholesale transmission sales.

***Employees***

On June 30, 2014, TEP had 1,427 employees, of which approximately 49% are represented by the IBEW Local 1116. A new collective bargaining agreement between the International Brotherhood of Electrical Workers ("IBEW") Local 1116 and TEP was entered into in January 2013 and expires in January 2016.

**UNS Electric**

UNS Electric is a regulated, vertically integrated electric utility company serving approximately 93,000 retail customers as at June 30, 2014 in Arizona's Mohave and Santa Cruz counties. These counties have a combined population of approximately 250,000. UNS Electric represented approximately 9% of the total assets of UNS Energy as of June 30, 2014 and approximately 12% of the operating revenues of UNS Energy for the six months ended June 30, 2014.

UNS Electric's customer base is primarily residential, with some commercial and industrial customers. Peak demand met by UNS Electric for 2013 was 423 MW. UNS Electric's annual retail customer growth rate was less than 1% from 2010 through 2013. UNS Electric typically records the majority of its net income during the second and third quarters when hot weather contributes to higher energy consumption.

***Power Supply and Transmission***

UNS Electric relies on a portfolio of long, intermediate and short-term purchases to meet customer load requirements. In addition, UNS Electric has generating resources which in 2013 met 152 MW or 36% of its 2013 peak demand.

Generating Resources

UNS Electric owns and operates the Black Mountain Generating Station ("BMGS"), a 90 MW gas-fired facility located near Kingman, Arizona. In July 2011, UNS Electric purchased BMGS from UNS Energy's subsidiary UED. UNS Gas purchases and transports natural gas to BMGS for UNS Electric under long-term natural gas transportation and sales agreements.

UNS Electric also owns and operates the Valencia Power Plant ("Valencia"), located in Nogales, Arizona. Valencia consists of four gas and diesel-fueled combustion turbine units and provides approximately 62 MW of peaking resources. The Valencia facility is directly interconnected with the distribution system serving the city of Nogales and the surrounding areas.

In December 2013, UNS Electric entered into an agreement to purchase 25% of Gila River Unit 3 (137 MW) for approximately US$55 million, with TEP purchasing the remaining 75% interest (413 MW). TEP and UNS Electric may modify the percentage ownership allocation between them. The purchase of Gila River is expected to close in December 2014, subject to, among other things, receipt of required regulatory approvals. The purchase of a 25% interest of Gila River Unit 3 would be consistent with UNS Electric's strategy to reduce its reliance on wholesale market purchases to meet retail customer demand.

Renewable Energy Resources

UNS Electric has agreed to purchase the output of a combined 10-MW wind farm and 0.5-MW solar generating facility located near Kingman. The above-market cost of energy purchased through the 20-year PPA will be recovered through UNS Electric's RES

surcharge. See “Regulation — Renewable Energy Standard and Tariff”. UNS Electric also expects to invest US$7 million in 2014 in company-owned solar PV capacity.

***Transmission***

UNS Electric imports the power generated at BMGS into its Mohave County and Santa Cruz County service territories over transmission lines owned by the Western Area Power Administration (“WAPA”). UNS Electric has transmission service agreements with WAPA for its transmission capacity that expire in June 2016. UNS Electric completed construction of a 138-kilovolt (“kV”) transmission line from Tucson to Nogales at the end of 2013. This project replaces a 115kV transmission line that previously linked UNS Electric’s load to the WAPA system. The new transmission line now connects UNS Electric’s load in Nogales directly to TEP’s high voltage transmission system. The connection to TEP’s system eliminates a requirement to run local generation in Nogales that was required due to limitations on the WAPA system.

***Employees***

On June 30, 2014, UNS Electric had 141 employees, of which 27 were represented by IBEW Local 387 and 87 were represented by IBEW Local 769. The existing agreements with IBEW Local 387 and IBEW Local 769 expire in February 2017 and June 2016, respectively.

**UNS Gas**

UNS Gas is a regulated gas distribution company serving approximately 150,000 retail customers in Arizona’s Mohave, Yavapai, Coconino, Navajo and Santa Cruz counties. These counties, with a combined population of approximately 700,000, comprise approximately 50% of the territory in the State of Arizona. UNS Gas represented approximately 6% of the total assets of UNS Energy as at June 30, 2014 and approximately 9% of the operating revenues of UNS Energy for the six months ended June 30, 2014.

The customer base of UNS Gas is primarily residential with sales to residential customers providing approximately 61% of the total revenues of UNS Gas in 2013. UNS Gas’ annual retail customer growth rate was less than 1% from 2010 through 2013. UNS Gas typically records peak demand during the winter months when cooler weather leads to heating demand. Accordingly, UNS Gas typically records the majority of its net income during the first and fourth quarters.

***Gas Supply and Transmission***

UNS Gas directly manages its gas supply and transportation contracts. The market price for gas varies based upon the period during which the commodity is purchased and is affected by weather, supply issues, the economy and other factors. UNS Gas hedges its gas supply prices by entering into fixed price forward contracts and financial swaps at various times during the year to ensure more stable prices for its customers. These purchases and hedges are made up to three years in advance with the goal of hedging at least 60% of the expected monthly gas consumption with fixed prices prior to the beginning of each month.

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

With EPNG, the average daily capacity right of UNS Gas is approximately 655,000 therms per day, with an average of 1,095,000 therms per day in the winter season (November through March) to serve its northern and southern Arizona service territories. UNS Gas has capacity rights of 230,000 therms per day on the San Juan Lateral and Mainline of the Transwestern pipeline. The Transwestern pipeline principally delivers gas to the portion of the UNS Gas distribution system serving customers in Flagstaff and Kingman and also the Griffith Power Plant in Mohave County.

UNS Gas signed a separate agreement with Transwestern for transportation capacity rights on the Phoenix Lateral Extension Line that expires in 2024. The average daily capacity right of UNS Gas on such line is 126,000 therms per day, with an average of 222,000 therms per day in the winter season.

*Employees*

On June 30, 2014, UNS Gas had 183 employees, of which 106 employees were represented by IBEW Local 1116 and 5 employees were represented by IBEW Local 387. The agreements with the IBEW Local 1116 and 387 expire in June 2015 and February 2017, respectively.

**Other Non-Regulated Segments**

The non-regulated businesses of UNS Energy, which comprises less than 1% of UNS Energy's total assets, include the operations of Millennium and UED. SES, a wholly owned subsidiary of Millennium, provides electrical contracting and meter reading services in Arizona, as well as other services at Springerville. On June 30, 2014, SES had 245 employees, of which 215 are represented by IBEW Local 1116 and 19 by IBEW Local 570. The collective bargaining agreement with IBEW Local 1116 expires in December 2014. The collective bargaining agreement with IBEW Local 570 expires in May 2016.

**Regulation**

The ACC is a regulatory body governed by the Arizona state constitution and is composed of five elected commissioners. Commissioners are elected state-wide for staggered four-year terms and are limited to serving a total of two terms.

The ACC regulates portions of TEP, UNS Electric and UNS Gas' utility accounting practices and energy rates. The ACC has authority over rates charged to retail customers, the siting of generation and transmission facilities, the issuance of securities and transactions with affiliated parties. The regulated utility rates for retail electric and natural gas service are determined by the ACC on a cost of service basis. Retail rates as set by the ACC are designed to provide recovery of allowable operating expenses and an opportunity to earn a reasonable return on rate base. Rate base is generally determined by reference to the original cost (net of depreciation) of utility plant in service, and to various adjustments for deferred taxes and other items, plus a working capital component. Over time, additions to utility plant in service increase rate base while depreciation of utility plant reduces rate base. The rates charged to retail customers by TEP, UNS Electric and UNS Gas also include pass-through mechanisms that allow each utility to recover the actual prudently incurred costs of its fuel, transmission and energy purchases to serve retail customers. FERC regulates the terms and prices of transmission services and wholesale electricity sales, wholesale transport and purchases of natural gas and portions of the accounting practices of TEP, UNS Electric and UNS Gas. As generators of electricity, each of TEP and UNS Electric have FERC tariffs to sell power at market-based rates.

*Renewable Energy Standard and Tariff*

The ACC's RES requires TEP, UNS Electric and other affected utilities to increase their use of renewable energy each year until it represents at least 15% of their total annual retail energy requirements in 2025. Affected utilities must file annual RES implementation plans for review and approval by the ACC. The approved cost of carrying out those plans is recovered from retail customers through the RES surcharge. Any RES surcharge collections above or below the costs incurred to implement the plans are deferred and reflected in the financial statements of the utility as a regulatory asset or liability. Both TEP and UNS Electric have complied with the RES implementation plans filed by each such utility with the ACC to date. TEP and UNS Electric expect to meet the 2014 renewable energy target of 4.5% of retail kilowatt-hour ("kWh") sales.

*Electric Energy Efficiency Standards and Decoupling*

In August 2010, the ACC approved new Electric Energy Efficiency Standards ("Electric EE Standards") designed to require TEP, UNS Electric and other affected electric utilities to implement cost-effective programs to reduce customers' energy consumption. The Electric EE Standards require increasing annual targeted retail kWh savings equal to 22% by 2020. Since the implementation of the Electric EE Standards, TEP's cumulative annual energy savings is approximately 4.4% of retail kWh sales and UNS Electric's cumulative annual energy savings is approximately 4.7% of retail kWh sales as of December 31, 2013.

New and existing DSM programs, direct load control programs and energy efficient building codes are acceptable means to meet the Electric EE Standards as set forth by the ACC. The Electric EE Standards provide for the recovery of costs incurred to implement DSM programs. DSM programs, and the rates charged to customers for such programs, are subject to annual review and approval by the ACC.

In 2010, the ACC issued a policy statement recognizing the need to adopt rate decoupling or another mechanism to make Arizona's Electric EE Standards viable. A decoupling mechanism is designed to encourage energy conservation by restructuring utility rates to separate the recovery of fixed costs from the level of energy consumed. The 2013 TEP Rate Order (as defined below) and the September 2013 UNS Electric settlement agreement with ACC staff, which was approved by the ACC on December 17, 2013, include partial decoupling mechanisms. See "Rates — TEP" and "Rates — UNS Electric".

***Gas Energy Efficiency Standards***

In 2010, the ACC approved Gas Energy Efficiency Standards ("Gas EE Standards") which are designed to require UNS Gas and other affected utilities to implement cost-effective DSM programs. Targeted savings increase annually in subsequent years until they reach a cumulative annual reduction in retail therm sales of 6% by 2020. Since the implementation of the Gas EE Standards in 2010, UNS Gas' customers have saved cumulative energy equal to approximately 0.5% of total retail therm sales as of December 31, 2013.

New and existing DSM programs, renewable energy technology that displaces gas, and certain energy efficient building codes are acceptable means to meet the Gas EE Standards. The Gas EE Standards provide for the recovery of costs incurred to implement DSM programs. UNS Gas' DSM programs and rates charged to retail customers for these programs are subject to ACC approval.

***Retail Electric Competition Rules***

In 1999, the ACC approved the Retail Electric Competition Rules (the "Rules") which provided a framework for the introduction of retail electric competition in Arizona. Certain portions of the ACC Rules that enabled Electric Service Providers ("ESPs") to compete in the retail market were invalidated by an Arizona Court of Appeals decision in 2004. In 2008, the ACC opened an administrative proceeding to address the Rules, and in 2012, several companies filed applications for a Certificate of Convenience and Necessity ("CC&N") with the ACC to provide competitive retail electric services in TEP's service territory as an ESP. Unless and until the ACC clarifies the Rules and/or grants a CC&N to an ESP, it is not possible for TEP's retail customers to use an alternative ESP.

In May 2013, the ACC voted to commence a process to consider the possibility of opening Arizona to retail electric competition. The first step in the process was to solicit comments on questions raised by the ACC on the potential benefits and risks to Arizona electric customers associated with retail electric competition. In July 2013, various parties, including TEP and UNS Electric, filed comments. TEP and UNS Electric oppose opening Arizona to retail electric competition. Responsive comments from the parties were filed in August 2013. In September 2013, the ACC voted to close the proceeding on retail competition, citing legal and constitutional challenges to which retail competition would be subject. The ACC decision to end its exploration into the deregulation of Arizona's electricity market signals improved coordination between the ACC, State utilities and industrial and commercial customers, and supports the improved views and ratings of Arizona's regulatory environment. UNS Energy cannot predict if the ACC will consider retail electric competition in the future. See "Risk Factors Relating to the Post-Acquisition Business and Operations of the Corporation and UNS Energy".

## Rates

***TEP***

In June 2013 the ACC issued the 2013 TEP rate order (the "2013 TEP Rate Order") that resolved the rate case filed by TEP in July 2012. The 2013 TEP Rate Order approved new rates for TEP effective July 1, 2013. The 2013 TEP Rate Order approved a non-fuel base rate increase of US$76 million over adjusted 2011 revenues, with an Original Cost Rate Base ("OCRB") of approximately US$1.5 billion and a Fair Value Rate Base ("FVRB") of approximately US$2.3 billion. In addition, the 2013 TEP Rate Order included a Lost Fixed Cost Recovery ("LFCR") mechanism to enable TEP to recover lost non-fuel costs due to lost kWh sales attributed to energy efficiency programs and distributed generation and an Environmental Compliance Adjustor ("ECA") mechanism that allows TEP to recover costs of complying with environmental standards required by federal or other governmental agencies between rate cases. The 2013 TEP Rate Order also approved adjustments and modifications to TEP's Purchased Power and Fuel Adjustment Clause mechanism, which permits TEP to pass through most fuel costs, including final reclamation costs, to customers.

The 2013 TEP Rate Order approved a 10.0% return on equity, a long-term cost of debt of 5.18% and a short-term cost of debt of 1.42%, resulting in a weighted average cost of capital of 7.26%. TEP's capital structure is permitted to be 43.5% equity, 56.0% long-term debt and 0.5% short-term debt. The provisions of the 2013 TEP Rate Order also give consideration to the fair value of

TEP's rate base by approving a 0.68% return on the incremental difference of approximately US$800 million between TEP's OCRB and its FVRB.

### *UNS Electric*

In December 2013, the ACC approved a new rate structure for UNS Electric that became effective on January 1, 2014 (the "2013 UNS Electric Rate Order"). The 2013 UNS Electric Rate Order provides for a non-fuel retail base rate increase of approximately US$3 million on an OCRB of approximately US$213 million and an FVRB of approximately US$283 million. The 2013 UNS Electric Rate Order approved a return on equity of 9.50% and a long-term cost of debt of 5.97% resulting in a weighted average cost of capital of 7.83%, with a capital structure of 52.6% equity and 47.4% long-term debt. The 2013 UNS Electric Rate Order also provides for (i) an LFCR mechanism to recover certain non-fuel costs relating to kWh sales lost due to energy efficiency programs and distributed generation and (ii) a transmission cost adjustor, which allows for more timely recovery of transmission costs associated with serving retail customers.

### *UNS Gas*

In April 2012, the ACC approved a base rate increase of US$2.7 million with an OCRB of US$183 million, as well as a LFCR mechanism to enable UNS Gas to recover lost fixed cost revenues as a result of implementing the Gas EE Standards. The LFCR mechanism is expected to recover lost fixed cost revenues of less than US$0.1 million in 2014, based on estimated lost retail therm sales from May 2012 through December 2013. The rate order approved by the ACC is based on a return on common shareholders' equity of 9.75%, common equity of 50.8% and long-term debt of 49.2%. The new rates became effective on May 1, 2012.

The Purchased Gas Adjustor ("PGA") mechanism is intended to address the volatility of natural gas prices and allow UNS Gas to recover its actual commodity costs, including transportation, through a price adjustor. The difference between UNS Gas' actual monthly gas and transportation costs and the rolling 12-month average cost of gas and transportation is deferred and recovered or returned to customers through the PGA mechanism. In October 2013, the ACC approved an increase to the existing PGA credit from 4.5 cents per therm to 10 cents per therm in order to reduce the US$17 million over-collected PGA balance as of September 30, 2013. The credit expired in April 2014. UNS Gas' PGA rate ranged from 0.4504 to 0.5280 cents per therm in 2013, and ranged from 0.5202 to 0.6501 cents per therm in 2012.

## Environmental Regulation

UNS Energy and its operations are subject to environmental regulation by federal, state and local bodies. The generating facilities of TEP and UNS Electric are primarily regulated by the United States Environmental Protection Agency (the "EPA"). Applicable environmental rules and regulations in the United States have changed significantly in the last five years and are expected to continue to evolve in ways that may limit, impair or add expense to the operations of UNS Energy and its regulated utility subsidiaries.

### *Hazardous Air Pollutant Requirements*

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

#### Navajo

Based on the MATS rules, Navajo may require mercury and particulate matter emission control equipment by April 2016. TEP's share of the estimated capital cost of this equipment is less than $1 million for mercury control and approximately US$43 million if the installation of baghouses to control particulates is necessary. The operator of Navajo is currently analyzing the need for baghouses under various regulatory scenarios, which will be affected by final Best Available Retrofit Technology ("BART") rules when issued. TEP expects its share of the annual operating costs for mercury control and baghouses to be less than US$1 million each.

San Juan

TEP expects San Juan's current emission controls to be adequate to comply with the MATS rules.

Four Corners

Based on the MATS rules, Four Corners may require mercury emission control equipment by April 2015. TEP's share of the estimated capital cost of this equipment is less than US$1 million. TEP expects its share of the annual operating cost of the mercury emission control equipment to be less than US$1 million.

Springerville Generating Station

Based on the MATS rules, Springerville Generating Station may require mercury emission control equipment by April 2016. The estimated capital cost of this equipment for Springerville Units 1 and 2 is approximately US$5 million. TEP expects the annual operating cost of the mercury emission control equipment to be approximately US$1 million. Estimated costs are split equally between the two units. TEP will own 49.5% of Springerville Unit 1 upon close of the lease option purchases in January 2015; after the completion of such purchases, third party owners will be responsible for 50.5% of environmental costs attributed to Springerville Unit 1. TEP will continue to be responsible for 100% of environmental costs attributable to Springerville Unit 2.

Sundt Generating Station

TEP expects the MATS rules will have little effect on capital expenditures at Sundt.

***Regional Haze Rules***

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

Complying with the EPA's BART findings, and with other future environmental rules, may make it economically impractical to continue operating the Navajo, San Juan and Four Corners power plants or for individual owners to continue to participate in these power plants. TEP cannot predict the ultimate outcome of these matters. See "Risk Factors Relating to the Post-Acquisition Business and Operations of the Corporation and UNS Energy".

Navajo

In January 2013, the EPA proposed a BART determination for the Navajo generating facility that would require the installation of Selective Catalytic Reduction ("SCR") technology on all three units at Navajo by 2023. In July 2013, SRP, along with other stakeholders including impacted government agencies, environmental organizations and tribal representatives submitted an agreement to the EPA that would achieve greater $NO_X$ emission reductions than the EPA's proposed BART rule. In September 2013, the EPA issued a supplemental proposal incorporating the provisions of the agreement as a better-than-BART alternative. Among other things, the agreement calls for the shutdown of one unit at Navajo or an equivalent reduction in emissions by 2020. The shutdown of one unit will not impact the total amount of energy delivered to TEP from Navajo. Additionally, the remaining Navajo participants would be required to install SCR or an equivalent technology on the remaining two units by 2030. As part of the agreement, the current owners have committed to cease their operation of conventional coal-fired generation at Navajo no later than December 2044. The Navajo Nation can continue operation after 2044 at its election. If SCR technology is ultimately implemented at Navajo, TEP estimates its share of the capital cost will be US$42 million. Also, the installation of SCR technology at Navajo could increase the power plant's particulate emissions which may require that baghouses be installed. TEP estimates that its share of the capital expenditure for baghouse installation would be approximately US$43 million. TEP's share of annual operating costs for SCR and baghouses is estimated at less than US$1 million each. The EPA could issue their decision in 2014.

San Juan

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

In 2011, Public Service Company of New Mexico ("PNM") filed a petition for review of, and a motion to stay, the FIP with the United States Court of Appeals for the Tenth Circuit ("Tenth Circuit"). In addition, the operator filed a request for reconsideration of the rule with the EPA and a request to stay the effectiveness of the rule pending the EPA's reconsideration and review by the Tenth Circuit. The State of New Mexico filed similar motions with the Tenth Circuit and the EPA. Several environmental groups were granted permission to join in opposition to PNM's petition to review in the Tenth Circuit. In addition, WildEarth Guardians filed a separate appeal against the EPA challenging the FIP's five-year implementation schedule. PNM was granted permission to join in opposition to that appeal. In March 2012, the Tenth Circuit denied PNM's and the State of New Mexico's motion for stay. Oral argument on the appeal was heard in October 2012.

In February 2013, the State of New Mexico, the EPA, and PNM signed a non-binding agreement ("Settlement Agreement") that outlines an alternative to the FIP. The terms of the Settlement Agreement include: the retirement of San Juan Units 2 and 3 by December 31, 2017; the replacement by PNM of those units with non-coal generation sources; and the installation of Selective Non-Catalytic Reduction technology ("SNCR") on San Juan Units 1 and 4 by January 2016 or later depending on the timing of EPA approvals. The New Mexico Environmental Department ("NMED") prepared a revision to the regional haze State Implementation Plan ("SIP") incorporating the provisions of the Settlement Agreement, and in September 2013, the New Mexico Environmental Improvement Board approved the SIP revision. In May 2014, the EPA proposed to approve the revised SIP and withdraw the existing FIP. The EPA is expected to make a final determination on the revised SIP in 2014. TEP estimates its share of the cost to install SNCR technology on San Juan Unit 1 would be approximately US$35 million. TEP's share of incremental annual operating costs for SNCR is estimated at US$1 million. TEP owns 340 MW, or 50%, of San Juan Units 1 and 2. If San Juan Unit 2 is retired, TEP's coal-fired generating capacity would be reduced by 170 MW.

In connection with the implementation of the SIP revision and the retirement of San Juan Units 2 and 3, some of the San Juan owner participants ("Participants") have expressed a desire to exit their ownership in the plant. As a result, the Participants are attempting to negotiate a restructuring of the ownership in San Juan, as well as addressing the obligations of the exiting Participants for plant decommissioning, mine reclamation, environmental matters, and certain ongoing operating costs, among other items. The Participants have engaged a mediator to assist in facilitating the resolution of these matters among the owners. The owners of the affected units also may seek approvals of their utility commissions or governing boards. We are unable to predict the outcome of the negotiations and mediation.

In October, 2013, the Tenth Circuit ruled on a motion filed by PNM for abatement of the pending petitions for review and seeking deferral of briefing on a simultaneously-filed motion to stay the FIP. The Tenth Circuit placed the pending petitions for review in abeyance and set a schedule for the parties to file status reports. The court ruled that, if at any time the Settlement Agreement is not implemented as contemplated, any party to the litigation may file a motion seeking to lift the abatement.

At June 30, 2014, the book value of TEP's share of San Juan Unit 2 was US$112 million. If Unit 2 is retired early, TEP expects to request ACC approval to recover, over a reasonable time period, all costs associated with the early closure of the unit. TEP cannot predict the ultimate outcome of this matter. See "Risk Factors Relating to the Post-Acquisition Business and Operations of the Corporation and UNS Energy".

Four Corners

In August 2012, the EPA finalized the regional haze FIP for Four Corners. The final FIP requires SCR technology to be installed on one unit by October 2016 and the remaining units by October 2017. In December 2013, APS, the operator of Four Corners, decided to shut down Units 1, 2, and 3 and install SCRs on Units 4 and 5. Under this scenario, the installation of SCR technology can be delayed until July 2018. TEP's estimated share of the capital costs to install SCR technology on Units 4 and 5 is approximately US$35 million. TEP's share of incremental annual operating costs for SCR is estimated at US$2 million.

Springerville

The BART provisions of the Regional Haze Rules requiring emission control upgrades do not apply to Springerville Units 1 and 2 since they were constructed in the 1980s which is after the time frame as designated by the rules. Other provisions of the Regional Haze Rules requiring further emission reduction are not likely to impact Springerville operations until after 2018.

Sundt

In July 2013, the EPA rejected the Arizona state implementation plan determination that Sundt Unit 4 is not subject to the BART provisions of the Regional Haze Rules and developed a timeline to issue a FIP for emissions sources including Sundt Unit 4. While TEP does not agree that Sundt Unit 4 is subject to BART, it submitted a better-than-BART proposal in November 2013 which called for the elimination of coal as a fuel source at Sundt by the end of 2017. In June 2014, the EPA issued a final BART rule that would require TEP to either (i) install, by mid-2017, SNCR and dry sorbent injection ("DSI") if Sundt Unit 4 continues to use coal as a fuel source, or (ii) permanently eliminate coal as a fuel source as a better-than-BART alternative by the end of 2017. TEP estimates that the cost to install SNCR and DSI would be approximately US$12 million, and the incremental annual operating costs would be in the range of US$5 million to US$6 million. Under the rule, TEP is required to notify the EPA of its decision by March 2017. At June 30, 2014, the net book value of the Sundt coal handling facilities was US$27 million. If the coal handling facilities are retired early, TEP expects to request ACC approval to recover, over a reasonable time period, all the remaining costs of the coal handling facilities.

***Greenhouse Gas Regulation***

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

In January 2014, the EPA published a re-proposed rule for new power plants. UNS Energy does not anticipate that a final rule related to new fossil-fueled power plant sources will have a significant impact on operations.

In June 2014, the EPA issued proposed carbon emission regulations for existing power plants called the Clean Power Plan. The Clean Power Plan targets a nation-wide reduction in carbon emissions of 30% by 2030. To achieve this goal, the proposed plan sets carbon emission rates for each state that must be achieved by an interim period of 2020-2029, with final rates by 2030. States can apply a variety of strategies to achieve the interim and final emission rates. Using 2012 as a baseline year, Arizona's carbon emission rate for 2030 represents a 52% reduction. The EPA expects to issue a final rule by June 2015, and under the current proposal, states must file implementation plans by June 2016 (or June 2017 for multi-state plans, with a possible one-year extension). UNS Energy cannot estimate the impact of the new proposed rule on its operations at this time.

UNS Energy will continue to work with federal and state regulatory agencies, and other neighboring utilities, to promote compliance flexibility in the rules impacting existing fossil-fuel fired power plants. TEP cannot predict the ultimate outcome of these matters, including the ability to recover these costs from customers through retail rates

***Coal Combustion Residuals***

The EPA is developing regulations for Coal Combustion Residuals ("CCRs") placed in landfills and surface impoundments (*i.e.* ponds). In June 2010, the EPA issued a proposed rule presenting for public comment two approaches for regulating CCRs: (i) as solid waste under Subtitle D of the Resource Conservation and Recovery Act ("RCRA"); and (ii) as hazardous waste under Subtitle C of RCRA. Both approaches would maintain an exception from regulation for beneficial use. In May 2014, the EPA entered a consent decree agreeing to take final action on the proposed rule as it relates to regulation under Subtitle D of RCRA by December 2014.

If the final rule is structured similar to existing "municipal solid waste" rules, TEP's ash disposal facility at Springerville would likely be in compliance with the requirements, however, upgrades could be required for future disposal. At Navajo and Four Corners, the ash that cannot be sold is land filled on site. These sites also could be required to upgrade. At San Juan, the ash that cannot be sold is returned to the mine. The proposed rule would not address mine placement of CCRs. Mine placement will be addressed through a separate rule-making under the oversight of the Department of Interior's Office of Surface Mining Reclamation and Enforcement. If the final rule regulates CCR as a "hazardous waste", in addition to the disposal facility upgrades discussed above, upgrades to

handling and storage facilities at the plant sites would also be required. TEP cannot determine the economic impact of this rule at this time.

*UNS Electric and UNS Gas*

UNS Electric and UNS Gas are each subject to environmental regulation of air and water quality, resource extraction, waste disposal and land use by federal, state and local authorities. The facilities and operations of UNS Electric and UNS Gas are in substantial compliance with existing regulations.

**Capital Expenditures**

Capital expenditures for the UNS Energy utility subsidiaries over the period from 2014 through 2018 are projected to total approximately US$2.0 billion. The estimated capital expenditures include the capital required to finance the anticipated acquisition of Gila River in 2014 and the capital required to exercise the Springerville Unit 1 lease purchase options in December 2014 and January 2015. See "TEP — Generating and Other Resources" and "TEP — Future Generating Resources".

**Projected Capital Expenditures (in US$ millions)**

| | Actual | | | Estimated | | |
|---|---|---|---|---|---|---|
| | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
| TEP | 253 | 528 | 469 | 223 | 276 | 218 |
| UNS Electric | 56 | 95 | 39 | 33 | 37 | 49 |
| UNS Gas | 17 | 13 | 13 | 14 | 15 | 16 |
| UNS Energy Consolidated | 326 | 636 | 521 | 270 | 328 | 283 |

Strong operating cash flows are expected to provide flexibility in the financing of capital expenditure projects. The majority of UNS Energy's capital investments are expected to be funded largely through internally generated operating cash flow and long-term debt issued by the UNS Utilities.

The rate base of UNS Energy is expected to grow by a compound annual growth rate of approximately 7% through 2018 as a result of capital expenditures related to UNS Energy's generation diversification, including increased generation from renewable resources, and meeting mandated emission reductions applicable to the regulated utility subsidiaries. The estimated capital expenditures in the table above include estimated capital required to comply with environmental regulations. See "Environmental Regulation".

*Operating and Maintenance Expense*

Base operating and maintenance ("O&M") expenses, including the cost of generating plant maintenance, represent the fundamental level of expenses related to maintaining UNS Energy's core business. UNS Energy management has maintained a focus on the control of base O&M. As a result, base O&M remained flat at an average of approximately US$267 million annually for 2009 through 2012. Base O&M expenses were US$288 million in 2013 (US$7 million of which is attributable to acquisition-related expenses) and are estimated to be in the range of US$285 million to US$295 million annually for 2014 through 2016, excluding acquisition-related expenses, which equates to an average annual growth rate of 1% since 2009.

The table below summarizes the items included in UNS Energy's O&M expense in 2013

| | (in US$ millions) |
|---|---|
| UNS Energy Base O&M …………………………………………………………………………………………… | 288 |
| Reimbursed Expenses Related to Springerville Units 3 and 4 ………………………………………………………… | 70 |
| Expense Related to Customer-Funded Renewable Energy and Demand Side Management Programs …………………. | 32 |
| Total UNS Energy O&M…………………………………………………………………………………………… | 390 |

### Outstanding Indebtedness

For information on the financial condition and results of UNS Energy, reference is made to the audited consolidated financial statements of UNS Energy and TEP as of December 31, 2013 and 2012, including the consolidated statements of income and cash flows for each of the years ended December 31, 2013, 2012 and 2011, and the unaudited consolidated financial statements of UNS Energy and TEP for the three and six months ended June 30, 2014, each of which is included in the Schedules to this Business Acquisition Report.

#### *Long-Term Debt and Capital Lease Obligations*

UNS Energy's long-term debt and capital lease obligations as of June 30, 2014 are described in the chart below. Fortis expects all such debt will remain in place for the current term of such obligation:

| Long-Term Debt | Maturity | Interest Rate | As of June 30, 2014 (millions of US$) |
|---|---|---|---|
| UNS Energy: | | | |
| Credit Agreement [1] | 2016 | Variable | 75 |
| TEP: | | | |
| Variable Rate Tax-Exempt Bonds [2] | 2018-2032 | Variable | 213 |
| Unsecured Fixed Rate Bonds | 2020-2040 | 4.50%-6.38% | 609 |
| Unsecured Notes | 2021-2044 | 3.85%-5.15% | 550 |
| UNS Electric and UNS Gas: | | | |
| Senior Unsecured Notes | 2015-2026 | 5.39%-7.10% | 200 |
| UNS Electric: | | | |
| Unsecured Term Loan | 2015 | Variable | 30 |
| Total Long-Term Debt | | | 1,677 |
| Capital Lease Obligations [3] | | | 343 |
| Total Long-Term Debt and Capital Lease Obligations | | | 2,020 |

(1) UNS Energy reflects borrowings under its revolving credit facility as long-term debt, as it has the ability and intention to leave the balance of its borrowings outstanding for at least the next twelve months.

(2) TEP also holds in treasury an aggregate of US$150 million of bonds issued by the Industrial Development Authority of the County of Apache which it may reissue or refund in the future. In the fourth quarter of 2013, TEP acquired an additional US$100 million of bonds issued by the Industrial Development Authority of the County of Apache, which bonds are subject to a mandatory tender for purchase in 2018 and mature in 2032. TEP used the proceeds of such bonds to redeem an existing series of outstanding bonds in the amount of US$100 million.

(3) Includes the long-term and current capital lease obligations with respect to TEP's leased interests in Springerville Unit 1, the Springerville Coal Handling Facilities and the Springerville Common Facilities. In August 2013, TEP recorded an increase of US$39 million due to TEP's commitment to purchase lease interests in January 2015. In October 2013, TEP recorded an increase of US$16 million for a commitment to purchase an additional lease interest in December 2014. In April 2014, TEP recorded an increase of US$109 million due to entering into agreements to purchase certain Springerville Coal Handling Facilities leased interests.

#### *Credit Facilities*

UNS Energy maintains a US$125 million stand-alone revolving credit facility (the "UNS Energy Credit Facility"), expiring in November 2016, to provide committed liquidity beyond its cash balance. The facility is secured by a pledge of the common stock of Millennium, UniSource Energy Services ("UES") and UED. At June 30, 2014, UNS had approximately US$50 million available under its revolver and US$2 million in cash and cash equivalents.

TEP currently maintains a US$200 million revolving credit, revolving letter of credit ("LOC") facility (the "TEP Credit Facility") and a US$82 million LOC facility (the "TEP LOC Facility") to support tax-exempt bonds, which expire in November 2016. In the second quarter of 2014, TEP issued a US$15 million LOC to a subsidiary of Entegra to satisfy a condition of the Gila River purchase agreement. TEP's borrowing capacity under the TEP Credit Agreement will be reduced by US$15 million until the Gila River transaction closes and the LOC is terminated. As of June 30, 2014, TEP had US$184 million available under the TEP Credit Facility.

UNS Gas and UNS Electric share a US$100 million revolving credit facility (the "UNS Electric/UNS Gas Credit Facility") that also expires in November 2016. Each utility's maximum draw under the facility is US$70 million but the total combined borrowed amount cannot exceed US$100 million and each utility is only liable for its own borrowings. As at June 30, 2014, UNS Gas had no borrowings under the revolver and US$18 million in cash and cash equivalents, while UNS Electric had US$23 million drawn on the revolver and US$4 million in cash and cash equivalents.

In August 2011, UNS Electric entered into a four-year US$30 million variable rate term loan credit agreement (the "UNS Electric Term Loan"). The interest rate currently in effect under this facility is three-month London Interbank Offer Rate ("LIBOR") plus 1.125%. At the same time, UNS Electric entered into a fixed-for-floating interest rate swap in which UNS Electric will pay a fixed rate of 0.97% and receive a three-month LIBOR rate on a US$30 million notional amount over a four-year period ending August 2015. The UNS Electric Term Loan is guaranteed by UNS Electric's immediate shareholder UES.

The UNS Energy Credit Facility, TEP Credit Facility, UNS Electric/UNS Gas Credit Facility and UNS Electric Term Loan contain restrictive covenants including restrictions on liens, mergers and sales of assets. These agreements also require that a certain maximum leverage ratio not be exceeded. At June 30, 2014, UNS Energy and its subsidiaries were in compliance in all material respects with the terms of their respective credit agreements, the TEP LOC Facility and the UNS Electric Term Loan. Compliance is not expected to be impacted by the acquisition of UNS Energy by Fortis.

**Risk Factors Relating to the Post-Acquisition Business and Operations of the Corporation and UNS Energy**

***Fortis has incurred a substantial amount of indebtedness which may adversely affect its cash flow and ability to operate its business***

Fortis has incurred a significant amount of debt, including US$2.0 billion of UNS Energy debt assumed by Fortis as a result of the Acquisition. As of June 30, 2014, on a *pro forma* basis after giving effect to the Acquisition and other refinancing activities, but assuming receipt of the Net Final Instalment Proceeds and conversion of all Convertible Debentures to Common Shares, Fortis would have had approximately $10.9 billion of total indebtedness outstanding. The change in the capital structure of Fortis as a result of the Acquisition, the assumed conversion of Convertible Debentures to Common Shares on receipt of the Net Final Instalment Proceeds and the drawdowns under the Acquisition Credit Facilities and Revolving Facility could cause credit rating agencies which rate the outstanding debt obligations of Fortis to re-evaluate and potentially downgrade the Corporation's current credit ratings, which could increase the Corporation's borrowing costs.

***The Corporation's historical and pro forma combined financial information may not be representative of the results of the Corporation following the Acquisition***

The *pro forma* combined financial information included in this Business Acquisition Report has been prepared using the consolidated historical financial statements of Fortis and the consolidated historical financial statements of UNS Energy and does not purport to be indicative of the financial information that will result from the operations of Fortis on a consolidated basis following the Acquisition. In addition, the *pro forma* combined financial information included in this Business Acquisition Report is based in part on certain assumptions regarding the Acquisition that Fortis currently believes are reasonable. Fortis makes no assurances that its current assumptions will prove to be accurate over time. Accordingly, the historical and *pro forma* financial information included in this Business Acquisition Report does not necessarily represent the Corporation's results of operations and financial condition had Fortis and UNS Energy operated as a combined entity during the periods presented, or of the Corporation's results of operations and financial condition in the future. The Corporation's potential for future business success and operating profitability must be considered in light of the risks, uncertainties, expenses and difficulties typically encountered by recently combined companies.

In preparing the *pro forma* financial information contained in this Business Acquisition Report, Fortis has given effect to, among other items, drawdowns under the Acquisition Credit Facilities and Revolving Facility, the completion of the Acquisition and the assumption of UNS Energy's and its subsidiaries' outstanding indebtedness. For the purpose of the *pro forma* financial information, Fortis has also assumed the Convertible Debentures are immediately converted into Common Shares following the payment in full of the final instalment therefor on the Final Instalment Date. While management believes that the estimates and assumptions underlying the *pro forma* financial information are reasonable, such assumptions and estimates may be materially different than the Corporation's actual experience following completion of the Acquisition. See the notes to the *pro forma* financial statements of Fortis incorporated in this Business Acquisition Report.

***Potential undisclosed liabilities associated with the Acquisition***

In connection with the Acquisition, there may be liabilities of UNS Energy and its subsidiaries that the Corporation failed to discover or was unable to quantify prior to the Acquisition. The discovery or quantification of any material liabilities of UNS Energy and its subsidiaries could have a material adverse effect on the Corporation's business, financial condition or future prospects.

***Fortis may not be successful in retaining the services of certain key personnel of UNS Energy***

Fortis intends to retain certain key personnel of UNS Energy to continue to manage and operate UNS Energy as a separate operating company. Fortis will compete with other potential employers for employees, and it may not be successful in keeping the services of the executives and other employees that it needs to realize the anticipated benefits of the Acquisition. The Corporation's failure to retain key personnel to remain as part of the management team of UNS Energy in the period following the Acquisition could have a material adverse effect on the business and operations of UNS Energy and Fortis on a consolidated basis.

***Fortis is subject to risks associated with its results of operations and financing risks***

Management of Fortis believes, based on its current expectations as to the Corporation's future performance (which reflects, among other things, the completion of the Acquisition), that the cash flow from its operations and funds available to it under its Revolving Facility and its ability to access capital markets will be adequate to enable the Corporation to finance its operations, execute its business strategy and maintain an adequate level of liquidity. However, expected revenue and the costs of planned capital expenditures are only estimates. Moreover, actual cash flows from operations are dependent on regulatory, market and other conditions that are beyond the control of the Corporation. As such, no assurance can be given that management's expectations as to future performance will be realized. In addition, management's expectations as to the Corporation's future performance reflect the current state of its information about UNS Energy and its operations and there can be no assurance that such information is correct and complete in all material respects.

The Corporation's degree of leverage could have adverse consequences for Fortis, particularly as a result of having drawn down an aggregate of approximately $2.3 billion under the Acquisition Credit Facilities and Revolving Facility to complete the Acquisition, if a significant portion of the Net Final Instalment Proceeds are not realized by Fortis and a significant portion of the Convertible Debentures are not converted into Common Shares by the holders thereof on or shortly following the Final Instalment Date. The significant increase in the degree of the Corporation's leverage could, among other things, limit the Corporation's ability to obtain additional financing for working capital, investment in subsidiaries, capital expenditures, debt service requirements, acquisitions and general corporate or other purposes; restrict the Corporation's flexibility and discretion to operate its business; limit the Corporation's ability to declare dividends on its Common Shares; require Fortis to dedicate a portion of cash flows from operations to the payment of interest on its existing indebtedness, in which case such cash flows will not be available for other purposes; cause rating agencies to re-evaluate or downgrade the Corporations' existing credit ratings; expose Fortis to increased interest expense on borrowings at variable rates; limit the Corporation's ability to adjust to changing market conditions; place Fortis at a competitive disadvantage compared to its competitors that have less debt; make Fortis vulnerable to any downturn in general economic conditions; and render Fortis unable to make expenditures that are important to its future growth strategies.

Within the next five years (from June 30, 2014), approximately $2.4 billion of the Corporation's consolidated indebtedness, including amounts associated with UNS Energy but excluding indebtedness incurred by the Corporation to finance the Acquisition, will become due. Therefore, the Corporation will need to refinance or reimburse amounts outstanding under the Corporation's existing consolidated indebtedness. There can be no assurance that any indebtedness of the Corporation will be refinanced or that additional financing on commercially reasonable terms will be obtained, if at all. In the event that such indebtedness cannot be refinanced, or if it can only be refinanced on terms that are less favourable than the current terms, the ability of the Corporation to declare dividends may be adversely affected.

The ability of the Corporation to meet its debt service requirements will depend on its ability to generate cash in the future, which depends on many factors, including the financial performance of the Corporation, debt service obligations, the realization of the anticipated benefits of the Acquisition and working capital and future capital expenditure requirements. In addition, the ability of the Corporation to borrow funds in the future to make payments on outstanding debt will depend on the satisfaction of covenants in existing credit agreements and other agreements. A failure to comply with any covenants or obligations under the Corporation's consolidated indebtedness could result in a default under one or more such instruments, which, if not cured or waived, could result in the termination of distributions by the Corporation and permit acceleration of the relevant indebtedness. If such indebtedness were to

be accelerated, there can be no assurance that the assets of the Corporation would be sufficient to repay such indebtedness in full. There can also be no assurance that the Corporation will generate cash flow in amounts sufficient to pay outstanding indebtedness or to fund any other liquidity needs.

***Jointly owned generating plants and generating plants operated by third parties***

Certain of the generating stations from which TEP receives power are jointly owned with, or are operated by, third parties. TEP may not have the sole discretion or any ability to affect the management or operations at such facilities. As a result of this reliance on other operators, TEP may not be able to ensure the proper management of the operations and maintenance of the plants. Further, TEP may have no ability or a limited ability to make determinations on how best to manage the changing environmental regime which affects such facilities. In addition, TEP will not have sole discretion as to how to proceed in the face of requirements relating to environmental compliance which could require significant capital expenditures or the closure of such generating stations. A divergence in the interests of TEP and the co-owners or operators, as applicable, of such generating facilities could negatively impact the business and operations of TEP.

***Pension and other employee benefit obligations of UNS Energy***

UNS Energy's future benefit obligations to employees were estimated to be US$94 million (net of fair value of plan assets) as at June 30, 2014. Economic fluctuations could adversely impact the funding and expenses associated with these obligations and there can be no assurance that these pension and employee benefit obligations will not increase materially in the future, thereby negatively impacting UNS Energy's results of operations, net income and cash flows, and those of Fortis following the Acquisition.

***National and local economic conditions can have a significant impact on the results of operations, net income and cash flows at UNS Energy and its subsidiaries***

The business of UNS Energy and the UNS Utilities is concentrated in the State of Arizona. In recent years economic conditions in the State of Arizona have contributed significantly to a reduction in TEP's retail customer growth and lower energy usage by the company's residential, commercial and industrial customers. As a result of weak economic conditions, TEP's average retail customer base grew by less than 1% in each year from 2009 through 2013 compared with average increases of approximately 2% in each year from 2004 to 2008. In 2013, total retail kWh sales were 0.2% above 2012 levels. Similar impacts were felt at UNS Gas and UNS Electric. Annual average increases in the number of retail customers at both companies remained below 1% in 2009 through 2013 compared with average annual growth rates of 3% from 2004 to 2008. While it is expected that economic conditions in the State of Arizona will improve in the future, if they do not or if they should worsen, retail customer growth rates may stagnate or decline and customers' energy usage may further decline, adversely affecting UNS Energy's results of operations, net income and cash flows and those of Fortis following the Acquisition.

***Stranded assets***

The coal-fired generating stations at San Juan, Four Corners, Navajo and Springerville, and the coal handling facilities at Sundt 4 may be required to be closed before the end of their useful lives in response to recent changes in environmental regulation, including potential regulation relating to $CO_2$ emissions. If any of the coal-fired generation plants, or coal handling facilities, from which TEP obtains power are closed prior to the end of their useful life, TEP could incur a material write-down of its assets and incur added expenses relating to the maintenance, decommissioning and cancellation of long-term coal contracts of such generating plants and facilities. Closure of any of such generating stations may force TEP to find higher cost replacement sources for the power it obtains from such generating facilities. TEP may not be permitted or entitled to seek reimbursement for such incremental increases in costs in the rates it charges its customers. See "Environmental Regulation".

***New technological developments and the implementation of new Electric EE Standards will continue to have a significant impact on retail sales, which could negatively impact UNS Energy's results of operations, net income and cash flows***

Heightened awareness of energy costs and environmental concerns has increased demand for products intended to reduce consumers' use of electricity. TEP and UNS Electric also are promoting DSM programs designed to help customers reduce their energy use and these efforts will increase significantly under energy efficiency rules approved in 2010 by the ACC and effective commencing in 2012. Unless the ACC makes a specific provision for the recovery of usage-based revenues lost to these energy

efficiency programs, the reduced retail sales that could result from the success of these efforts could negatively impact the results of operations, net income and cash flows of TEP and UNS Electric and those of Fortis following the Acquisition.

***Developments in technology could reduce demand for electricity***

Research and development activities are ongoing for new technologies that produce power or reduce power consumption. These technologies include renewable energy, customer-oriented generation, energy efficiency and more energy efficient appliances and equipment. Advances in these, or other technologies, could reduce the cost of producing electricity or make the existing generating facilities of UNS Energy less economical. In addition, advances in such technologies could reduce electrical demand, which could negatively impact the results of operations, net income and cash flows of TEP and UNS Electric and those of Fortis following the Acquisition.

***The revenues, results of operations and cash flows of the UNS Utilities are seasonal and are subject to weather conditions and customer usage patterns***

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

***TEP and UNS Electric are dependent on a small segment of large customers for future revenues. A reduction in the electricity sales to these customers would negatively affect the companies' results of operations, net income, and cash flows***

TEP and UNS Electric sell electricity to mines, military installations, and other large industrial customers. In 2013, 35% of TEP's retail kWh sales, and 14% of UNS Electric's retail kWh sales, were to industrial and mining customers. Retail sales volumes and revenues from these customer classes could decline as a result of, among other things: economic conditions; decisions by the federal government to close military bases; the effects of energy efficiency and distributed generation; or the decision by customers to self-generate all or a portion of the energy needs. A reduction in retail kWh sales to TEP's and UNS Electric's large customers would negatively impact their results of operations, net income, and cash flows and those of Fortis following the Acquisition.

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

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

The ACC is charged with setting retail electric and gas rates that provide utility companies in Arizona with an opportunity to recover their costs of service and earn a reasonable rate of return. ACC rate orders also regulate average cost of capital and the capital structure of the UNS Utilities, among other things, which limits the discretion of management in respect of the manner in which it runs such businesses. As part of the process of establishing the retail electric and gas rates charged by TEP, UNS Electric and UNS Gas, the ACC could disallow the recovery of any costs it determines were not prudently incurred. The decisions of these elected officials on such matters impact the net income and cash flows of the UNS Utilities and those of Fortis following the Acquisition.

In May 2013, the ACC initiated and subsequently closed an inquiry to discuss the possibility of opening Arizona to retail electric competition. If the ACC ultimately decides to implement retail electric competition in Arizona, it could negatively impact the results of operations, net income and cash flows of TEP and UNS Electric and those of Fortis following the Acquisition. See "Regulation".

***Changes in US federal energy regulation may negatively affect the results of operations, net income and cash flows of the UNS Utilities***

The UNS Utilities are subject to the impact of comprehensive and changing governmental regulation at the federal level in the United States that continues to change the structure of the electric and gas utility industries and the ways in which these industries are

regulated. The UNS Utilities are subject to regulation by FERC. FERC has jurisdiction over rates for electric transmission in interstate commerce and rates for wholesale sales of electric power, including terms and prices of transmission services and sales of electricity at wholesale prices. Changes in regulations by FERC may negatively affect the results of operations, net income and cash flows of the UNS Utilities and those of Fortis following the Acquisition.

***The UNS Utilities are subject to numerous environmental laws and regulations that may increase their cost of operations or expose them to environmentally-related litigation and liabilities. Many of these regulations could have a significant impact on TEP due to its reliance on coal as its primary fuel for electricity generation***

Numerous federal, state and local environmental laws and regulations in the United States and the State of Arizona affect present and future operations of UNS Energy's regulated utility subsidiaries. Those laws and regulations include rules regarding air emissions, water use, wastewater discharges, solid waste, hazardous waste and management of CCRs.

These laws and regulations can contribute to higher capital, operating and other costs, particularly with regard to enforcement efforts focused on existing power plants and new compliance standards related to new and existing power plants. These laws and regulations generally require TEP and UNS Electric to obtain and comply with a wide variety of environmental licenses, permits, authorizations and other approvals. Both public officials and private individuals may seek to enforce applicable environmental laws and regulations against UNS Energy and its regulated utility subsidiaries. Failure to comply with applicable laws and regulations may result in litigation, the imposition of civil or criminal fines and penalties and a requirement for costly equipment upgrades by regulatory authorities against UNS Energy and its regulated utility subsidiaries.

Existing environmental laws and regulations may be revised or new environmental laws and regulations may be adopted or become applicable to the facilities and operations of the UNS Utilities. Increased compliance costs or additional operating restrictions from revised or additional regulation could have an adverse effect on the results of operations of the UNS Utilities. The UNS Utilities would request that additional costs resulting from environmental laws and regulation be recovered from customers through regulated rates. TEP's obligation to comply with the EPA's BART determinations as a participant in the San Juan, Four Corners and Navajo electricity generating plants, coupled with the financial impact of future climate change legislation, other environmental regulations and other business considerations, could jeopardize the economic viability of these electricity generating plants or the ability of individual participants to meet their obligations and continue their participation in these electricity generating plants. TEP cannot predict the ultimate outcome of these matters.

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

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

Based on the finding by the EPA in December 2009 that emissions of greenhouse gases endanger public health and welfare, the agency is in the process of regulating greenhouse gas emissions. In addition, there are proposals and ongoing studies at the state, federal and international levels to address global climate change that could also result in the regulation of $CO_2$ and other greenhouse gases. Any future regulatory actions taken to address global climate change represent a business risk to the operations of UNS Energy. In 2013, 80% of TEP's total energy resources came from its coal-fueled generating facilities.

Reductions in $CO_2$ emissions to the levels specified by some proposals could be materially adverse to the financial position or results of operations of UNS Energy if associated costs of control or limitation cannot be recovered from customers. In June 2013, President Obama directed the EPA to move forward with carbon emission regulations for both new and existing fossil-fueled power plants. Under the President's Climate Action Plan, the EPA proposed carbon emission standards on June 2, 2014; is required to finalize those standards by June 1, 2015; and will require states to submit their implementation plans to meet the standards by June 30, 2016. Changes to existing environmental laws applicable to the generating assets of TEP and UNS Electric could negatively impact the ability of certain of the generating plants to operate on an economically viable basis or at all and could result in significant capital expenditures being required to bring such plants into compliance with any new legislation. There is a particular risk that any new rules proposed by the EPA will significantly impair the ability to operate certain of TEP's coal-fired generation plants on an economically viable basis or at all. If any of the coal-fired generation plants from which TEP obtains power were closed prior to the

end of their useful lives, TEP would likely be forced to find replacement sources for the power it obtains from such generating facilities at increased cost and could incur a material write-down of its assets. The impact of legislation or regulation to address global climate change would depend on the specific terms of those measures and cannot be determined at this time.

***Failure to meet renewable energy standards and gas energy efficiency standards***

The ACC's renewable energy standards require TEP and UNS Electric to increase their use of renewable energy each year until it represents at least 15% of their total annual retail energy requirements in 2025. Further, in 2010, the ACC approved Gas EE Standards and Electric EE Standards which are designed to require TEP, UNS Electric and UNS Gas to implement cost effective programs to reduce customers' energy consumption. There is a possibility that these renewable energy standards and gas efficiency standards will not be met which may result in regulatory sanctions and adverse financial consequences to TEP, UNS Electric or UNS Gas.

***Volatility or disruptions in the financial markets may increase UNS Energy's financing costs, limit access to the credit markets and increase pension funding obligations, which may adversely affect UNS Energy's liquidity and ability to carry out its financial strategy***

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

Changing market conditions could negatively affect the market value of assets held in the pension and other retiree plans of UNS Energy and may increase the amount and accelerate the timing of required future funding contributions. See "— Pension and other employee benefit obligations of UNS Energy".

***TEP, UNS Electric and UNS Gas are subject to wholesale credit risk***

TEP, UNS Electric and UNS Gas are subject to credit risk related to their respective wholesale sales, purchases, procurement and hedging activities. This includes the risk of non-payment on power sales and delivery risk on power and gas purchases. All three companies have forward physical and financial contracts which may result in positive mark-to-market values which are subject to default risk. Significant levels of default or non-payment in connection with these activities would have an adverse impact on the financial condition of the UNS Utilities and Fortis following the Acquisition.

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

At December 31, 2013, TEP had US$215 million of tax-exempt variable rate debt obligations, US$50 million of which was hedged with a fixed-for-floating interest rate swap through September 2014. The variable interest rates are set weekly with maximum interest rates of 20% on US$178 million of debt obligations and 10% on the remaining US$37 million. The average weekly interest rate ranged from 0.06% to 0.48% in 2013.

UNS Energy, TEP, UNS Electric and UNS Gas also are subject to risk resulting from changes in the interest rate on their borrowings under revolving credit facilities. Revolving credit borrowings may be made on a spread over LIBOR or an Alternate Base Rate. Each of these agreements is a committed facility and expires in November 2016.

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

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

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

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

The maximum amount TEP may use under the TEP Credit Facility is US$200 million. As of June 30, 2014, TEP had US$184 million available to borrow under the TEP Credit Facility. The maximum amount UNS Gas or UNS Electric may borrow is US$70 million, so long as the combined amount drawn by both companies does not exceed US$100 million (the size of their combined borrowing capacity under the UNS Electric/UNS Gas Credit Facility). As of June 30, 2014, UNS Gas had US$70 million and, UNS Electric had US$47 million available to borrow under the UNS Electric/UNS Gas Credit Facility. From time to time, TEP, UNS Electric and UNS Gas use their respective revolving credit facilities to post collateral. If additional collateral is required, it may negatively impact TEP, UNS Electric and/or UNS Gas' ability to fund their capital requirements. As of June 30, 2014, TEP and UNS Electric each had posted less than US$1 million with counterparties in the form of cash or LOCs.

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

UNS Energy has no operations of its own and derives all of its revenues and cash flow from its subsidiaries. At December 31, 2013, the ratio of total debt (including capital lease obligations net of investments in lease debt) to total capitalization for UNS Energy and its subsidiaries was 62%. This debt level:

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

***The cost of purchasing TEP's leased assets and the cost of procuring alternate sources of generation or purchased power in 2015 could require significant outlays of cash in a short period of time, which could be difficult to finance***

In 2013, TEP exercised purchase options with respect to an additional aggregate 35.4% undivided interest in Springerville Unit 1 from the owner participants at an aggregate purchase price of approximately US$65 million, with the closing of the lease purchase options scheduled to occur in December 2014 and January 2015. In 2015, following the acquisition by TEP of the additional 35.4% interest in Springerville Unit 1 and the expiry of the Springerville Unit 1 Leases, the capacity received by TEP from this facility will be reduced to 49.5% of the continuous operating capability of Springerville Unit 1.

In December 2013, TEP and UNS Electric entered into a purchase agreement to acquire Gila River, a natural gas-fired combined-cycle unit with a capacity rating of 550 MW. The transaction is expected to close in late 2014, upon which TEP and UNS Electric will be required to fund the purchase amount of US$219 million.

In April 2014, TEP committed to the purchase of the Springerville Coal Handling Facilities at the fixed price of US$120 million upon the expiration of the lease term in April 2015. TEP also leases a 50% undivided interest in the Springerville Common Facilities with primary lease terms ending in 2017 and 2021. Upon expiration of the Springerville Common Facilities Leases (whether at the end of the initial term or any renewal term), TEP has the obligation under agreements with the owners of Springerville Units 3 and 4 to purchase such facilities. Upon acquisition by TEP, the owner of Springerville Unit 3 has the option and the owner of Springerville

Unit 4 has the obligation to purchase from TEP a 14% interest in the Common Facilities and a 17% interest in the Coal Handling Facilities.

In 2014 and 2015, TEP's capital expenditures related to investments in its high voltage transmission system are expected to be US$147 million.

The anticipated purchase by TEP (and UNS Electric, in respect of Gila River) of the additional 35.4% interest in Springerville Unit 1, Gila River and the Springerville Coal Handling Facilities in 2014 and 2015 as well as TEP's expected capital expenditures in respect of its high voltage transmission system will result in significant capital expenditures by TEP in a short period of time.

***Regulatory rules and other restrictions could limit the ability of the UNS Utilities to make distributions to UNS Energy***

As a holding company, UNS Energy is dependent on the earnings and distributions of funds from its subsidiaries to service its debt. Several restrictions could preclude the ability of any of the UNS Utilities to transfer funds to UNS Energy, including the following:

- TEP, UNS Electric and UNS Gas are restricted from lending to affiliates or issuing securities without ACC approval;
- the Federal Power Act states that an electric utility's dividends shall not be paid out of funds properly included in capital accounts. Although TEP now has a positive balance of retained earnings as of June 30, 2014, TEP has historically had an accumulated deficit rather than positive retained earnings. UNS Energy currently believes that there is a reasonable basis for TEP to pay dividends from current year earnings even if it were to have an accumulated deficit. However, there can be no assurance that FERC would permit such dividend payments;
- TEP, UNS Electric and UNS Gas must be in compliance with their respective debt agreements in order to make dividend payments to UNS Energy; and
- until the earlier of (i) August 15, 2019 and (ii) such time as a UNS Utility's equity capitalization reaches 50% of total capital (excluding any goodwill recorded), dividends paid by such UNS Utility to UNS Energy cannot exceed 60% of such UNS Utility's net income.

Restrictions of this nature could limit the ability of UNS Energy to pay dividends to Fortis and could negatively impact the realization of the anticipated benefits of the Acquisition by Fortis.

***Unanticipated financing needs or reductions to net income could adversely impact the ability to comply with financial covenants in the UNS Energy, TEP and UNS Electric Credit Agreements***

The UNS Energy, TEP and UNS Electric credit and reimbursement agreements include a maximum leverage ratio. The leverage ratios are calculated as the ratio of total indebtedness to total capital. The ability to comply with these covenants could be adversely impacted by unanticipated borrowing needs or unexpected charges to earnings or shareholder equity. In the event that UNS Energy, TEP or UNS Electric seek to renegotiate these provisions to provide additional flexibility, they may need to pay fees or increased interest rates on borrowings as a condition to any amendments or waivers.

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

The operation of electric generating stations involves certain risks, including equipment breakdown or failure (due to wear and tear, latent defect, design error or operator error, among other things), interruption of fuel supply and lower than expected levels of efficiency or operational performance. Unplanned outages, including extensions of planned outages due to equipment failure or other complications, occur from time to time and are an inherent risk of the businesses of TEP and UNS Electric. There can be no assurance that the generation facilities of TEP or UNS Electric will continue to operate in accordance with expectations. If an unplanned outage or an equipment breakdown occurs, TEP or UNS Electric could be adversely affected. In addition, any applicable insurance coverage may not be adequate to protect the business of TEP and UNS Electric from material adverse effects as a result of such operational failures.

***Operations may be adversely affected if water supply is materially reduced***

Natural gas and coal-fired plants require continuous water flow for their operation. Shifts in weather or climate patterns, seasonable precipitation, the timing and rate of melting, run off, and other factors beyond the control of TEP and UNS Electric, may reduce the water flow to their generation facilities. Any material reduction in the water flow to such facilities would limit the ability of TEP and UNS Electric to produce and market electricity from such facilities and could have a material adverse effect on the business of each such company. Further, any change in regulations or the level of regulation respecting the use, treatment and discharge of water, or respecting the licensing of water rights in the jurisdictions where TEP and UNS Electric operate could result in a material adverse effect on the business of each such company.

***Disruption of fuel supply could have an adverse impact on the financial condition of the UNS Utilities***

The UNS Utilities depend on third parties to supply fuel, including natural gas and coal. As a result, there are risks of supply interruptions and fuel price volatility, as fuel deliveries may not exactly match those required for energy sales or use in electricity production, due in part to the need to pre-purchase fuel inventories for reliability and dispatch requirements. Disruption of transportation services for fuel, whether because of weather-related problems, strikes, lock-outs, break-downs of locks and dams, pipeline failures or other events could impair the ability to deliver electricity or gas or generate electricity and could adversely affect operations. Further, the loss of coal suppliers or the inability to renew existing coal and natural gas contracts at favorable terms could significantly affect the ability to serve customers and have an adverse impact on the financial condition and results of operations of the UNS Utilities and Fortis following the Acquisition.

***The facilities and operations of UNS Energy could be affected by natural disasters or other catastrophic events***

UNS Energy's facilities and operations are exposed to potential damage and partial or complete loss resulting from environmental disasters (e.g. floods, high winds, fires and earthquakes), equipment failures, vandalism, potentially catastrophic events such as a major accident or incident at one of the sites, and other events beyond the control of UNS Energy. The operation of transmission and distribution systems involves certain risks, including gas leaks, fires, explosions, pipeline ruptures and other hazards and risks that may cause unforeseen interruptions, personal injury or property damage. Any such incident could have an adverse effect on UNS Energy and Fortis following the Acquisition. In certain cases, there is potential that some events may not excuse UNS Energy and its utility subsidiaries from performing obligations pursuant to agreements with third parties.

***TEP could be subject to higher costs and the possibility of significant penalties as a result of mandatory transmission standards***

As a result of the Energy Policy Act of 2005, owners and operators of bulk power transmission systems, including TEP, are subject to mandatory transmission standards developed and enforced by NERC and subject to the oversight of FERC. Compliance with modified or new transmission standards may subject TEP to higher operating costs and increased capital costs. Failure to comply with the mandatory transmission standards could subject TEP to sanctions, including substantial monetary penalties.

***UNS Energy may be subject to cyber-attacks and information security risks***

As operators of critical energy infrastructure, UNS Energy and its regulated utility subsidiaries may face a heightened risk of cyber-attack and their corporate and information technology systems may be vulnerable to disability or failures as a result of unauthorized access due to hacking, viruses, acts of war or terrorism and other causes. In addition, the utility business requires access to sensitive customer data, including personal and credit information, in the ordinary course of business. If, despite the security measures of UNS Energy and its regulated utility subsidiaries, a significant or widely publicized breach occurred, UNS Energy and its regulated utility subsidiaries could have their operations disrupted, property damaged and customer information stolen, experience substantial loss of revenues, response costs and other financial loss; and be subject to increased regulation, litigation and damage to their reputation, any of which could have a negative impact on the business and results of operations of UNS Energy and its regulated utility subsidiaries and Fortis following the Acquisition.

***TEP or UNS Electric might not be able to secure adequate rights-of-way to construct transmission lines and distribution related facilities and could be required to find alternate ways to provide adequate sources of energy and maintain reliable service for their customers***

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

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

***TEP and UNS Electric rely on transmission lines they do not own or control, which may hinder their ability to produce, sell and deliver electricity***

TEP and UNS Electric depend on transmission and distribution facilities that are owned and operated by other utilities and power companies to deliver some of the electricity that they generate. An extended disruption in transmission, a failure in any such transmission system or a lack of available transmission and distribution facilities could impact the ability of TEP and UNS Electric to produce, sell and deliver electricity, which could result in a material adverse effect to the respective businesses of such companies and Fortis following the Acquisition.

***Labour Relations***

The organized employees of the UNS Utilities are members of labour unions which have entered into collective bargaining agreements with their respective employer. The provisions of such collective bargaining agreements affect the flexibility and efficiency of the business carried on by the UNS Utilities. The UNS Utilities consider their relationships with their respective labour unions to be satisfactory, but there can be no assurance that current relations will continue in future negotiations or that the terms under the present collective bargaining agreements will be renewed. Collective bargaining agreements covering certain employees of TEP, UNS Gas and UNS Electric expire in 2015 and 2016. The inability to maintain, or to renew the collective bargaining agreements on acceptable terms, could result in increased labour costs or service interruptions arising from labour disputes for the UNS Utilities, which could have an adverse effect on the results of operations, cash flow and net income of such companies and on UNS Energy and Fortis following the Acquisition.

***Underinsured and Uninsured Losses***

UNS Energy and the UNS Utilities maintain at all times insurance coverage in respect of potential liabilities and the accidental loss of value of certain of their assets from risks, in amounts considered appropriate, taking into account all relevant factors including the practices of owners of similar assets and operations. It is anticipated that such insurance coverage will be maintained. However, not all risks are covered by insurance and no assurance can be given that insurance will be consistently available or will be consistently available on economically feasible terms or that the amounts of insurance will be sufficient to cover losses or claims that may occur involving the assets or operations of UNS Energy or any of the UNS Utilities.

## SCHEDULE B

## UNS Energy Corporation and Tucson Electric Power Company

## Consolidated Financial Statements
## Years ended December 31, 2013, 2012, and 2011

## Together with Auditor's Reports

## Report of Independent Registered Public Accounting Firm

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

In our opinion, the accompanying consolidated balance sheets and statements of capitalization and the related consolidated statements of income, comprehensive income, cash flows, and changes in stockholders' equity present fairly, in all material respects, the financial position of UNS Energy Corporation and its subsidiaries at December 31, 2013 and December 31, 2012, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of the financial 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.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

Phoenix, Arizona
February 25, 2014, except for the effects of the revision discussed in Note 1 to the consolidated financial statements, as to which the date is August 14, 2014

## Report of Independent Registered Public Accounting Firm

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

In our opinion, the accompanying consolidated balance sheets and statements of capitalization and the related consolidated statements of income, comprehensive income, cash flows and changes in stockholder's equity present fairly, in all material respects, the financial position of Tucson Electric Power Company and its subsidiaries at December 31, 2013 and December 31, 2012, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements 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.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Phoenix, Arizona

February 25, 2014, except for the effects of the revision discussed in Note 1 to the consolidated financial statements, as to which the date is August 14, 2014

**UNS ENERGY CORPORATION**
**CONSOLIDATED STATEMENTS OF INCOME**

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2013 | 2012 | 2011 |
| | Thousands of Dollars (Except Per Share Amounts) | | |
| **Operating Revenues** | | | |
| Electric Retail Sales | $ **1,102,769** | $ 1,087,279 | $ 1,085,822 |
| Electric Wholesale Sales | **135,160** | 125,414 | 132,346 |
| Gas Retail Sales | **125,478** | 123,133 | 145,053 |
| Other Revenues | **121,153** | 125,940 | 115,481 |
| **Total Operating Revenues** | **1,484,560** | 1,461,766 | 1,478,702 |
| **Operating Expenses** | | | |
| Fuel | **332,279** | 327,832 | 324,520 |
| Purchased Energy | **252,532** | 224,696 | 276,610 |
| Transmission and Other PPFAC Recoverable Costs | **23,012** | 14,540 | 7,334 |
| Increase (Decrease) to Reflect PPFAC/PGA Recovery Treatment | **(16,313)** | 32,246 | (4,932) |
| **Total Fuel and Purchased Energy** | **591,510** | 599,314 | 603,532 |
| Operations and Maintenance | **389,699** | 383,689 | 379,220 |
| Depreciation | **149,615** | 141,303 | 133,832 |
| Amortization | **27,557** | 35,784 | 30,983 |
| Taxes Other Than Income Taxes | **54,683** | 49,881 | 49,428 |
| **Total Operating Expenses** | **1,213,064** | 1,209,971 | 1,196,995 |
| **Operating Income** | **271,496** | 251,795 | 281,707 |
| **Other Income (Deductions)** | | | |
| Interest Income | **534** | 1,106 | 4,568 |
| Other Income | **7,880** | 4,928 | 7,958 |
| Other Expense | **(3,463)** | (7,723) | (5,278) |
| Appreciation in Fair Value of Investments | **2,833** | 1,892 | 329 |
| **Total Other Income (Deductions)** | **7,784** | 203 | 7,577 |
| **Interest Expense** | | | |
| Long-Term Debt | **71,180** | 71,909 | 73,217 |
| Capital Leases | **25,140** | 33,613 | 40,359 |
| Other Interest Expense | **538** | 1,983 | 2,535 |
| Interest Capitalized | **(3,483)** | (2,153) | (3,753) |
| **Total Interest Expense** | **93,375** | 105,352 | 112,358 |
| **Income Before Income Taxes** | **185,905** | 146,646 | 176,926 |
| Income Tax Expense | **58,427** | 55,727 | 66,951 |
| **Net Income** | $ **127,478** | $ 90,919 | $ 109,975 |
| **Weighted-Average Shares of Common Stock Outstanding (000)** | | | |
| Basic | **41,618** | 40,362 | 36,962 |
| Diluted | **41,975** | 41,755 | 41,609 |
| **Earnings Per Share** | | | |
| Basic | $ **3.06** | $ 2.25 | $ 2.98 |
| Diluted | $ **3.04** | $ 2.20 | $ 2.75 |
| **Dividends Declared Per Share** | $ **1.74** | $ 1.72 | $ 1.68 |

See Notes to Consolidated Financial Statements.

**UNS ENERGY CORPORATION**
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2013 | 2012 | 2011 |
| | Thousands of Dollars | | |
| **Comprehensive Income** | | | |
| Net Income | **$ 127,478** | $ 90,919 | $ 109,975 |
| **Other Comprehensive Income (Loss)** | | | |
| Net Changes in Fair Value of Cash Flow Hedges, net of income tax (expense) benefit of $(1,850), $(743), and $964 | **2,825** | 1,134 | (1,473) |
| SERP Benefit Amortization, net of income tax (expense) benefit of $(572), $608, and $(804) | **916** | (840) | 1,158 |
| **Total Other Comprehensive Income (Loss), Net of Tax** | **3,741** | 294 | (315) |
| **Total Comprehensive Income** | **$ 131,219** | $ 91,213 | $ 109,660 |

See Notes to Consolidated Financial Statements.

## UNS ENERGY CORPORATION
## CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Years Ended December 31, | | |
|---|---|---|---|
| | **2013** | **2012** | **2011** |
| | | Thousands of Dollars | |
| **Cash Flows from Operating Activities** | | | |
| Cash Receipts from Electric Retail Sales | **$ 1,208,967** | $ 1,197,390 | $ 1,163,537 |
| Cash Receipts from Electric Wholesale Sales | **160,947** | 149,722 | 183,151 |
| Cash Receipts from Gas Retail Sales | **138,775** | 141,590 | 159,529 |
| Cash Receipts from Operating Springerville Units 3 & 4 | **114,258** | 107,927 | 104,754 |
| Cash Receipts from Gas Wholesale Sales | **3,740** | 5,233 | 12,404 |
| Interest Received | **517** | 2,947 | 6,334 |
| Income Tax Refunds Received | **11** | 1,821 | 4,672 |
| Performance Deposits Received | **—** | 200 | 7,050 |
| Other Cash Receipts | **35,142** | 24,105 | 23,937 |
| Fuel Costs Paid | **(285,812)** | (321,355) | (277,386) |
| Purchased Energy Costs Paid | **(280,920)** | (250,231) | (328,713) |
| Payment of Operations and Maintenance Costs | **(260,453)** | (291,512) | (295,662) |
| Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized | **(182,488)** | (187,257) | (179,766) |
| Wages Paid, Net of Amounts Capitalized | **(131,710)** | (127,176) | (122,370) |
| Interest Paid, Net of Amounts Capitalized | **(66,610)** | (69,478) | (68,027) |
| Capital Lease Interest Paid | **(22,553)** | (28,788) | (32,103) |
| Income Taxes Paid | **(316)** | — | (700) |
| Performance Deposits Paid | **—** | (200) | (4,550) |
| Wholesale Gas Costs Paid | **—** | — | (11,822) |
| Other Cash Payments | **(10,983)** | (6,829) | (6,949) |
| **Net Cash Flows—Operating Activities** | **420,512** | 348,109 | 337,320 |
| **Cash Flows from Investing Activities** | | | |
| Capital Expenditures | **(325,886)** | (307,277) | (374,122) |
| Purchase of Intangibles—Renewable Energy Credits | **(26,948)** | (10,317) | (5,992) |
| Return of Investments in Springerville Lease Debt | **9,104** | 19,278 | 38,353 |
| Change in Restricted Cash | **4,134** | (1,445) | — |
| Proceeds from Note Receivable | **—** | 15,000 | — |
| Other, net | **5,786** | 21,862 | 14,673 |
| **Net Cash Flows—Investing Activities** | **(333,810)** | (262,899) | (327,088) |
| **Cash Flows from Financing Activities** | | | |
| Proceeds from Borrowings Under Revolving Credit Facilities | **139,000** | 359,000 | 391,000 |
| Repayments of Borrowings Under Revolving Credit Facilities | **(108,000)** | (381,000) | (351,000) |
| Payments of Capital Lease Obligations | **(99,621)** | (89,452) | (74,381) |
| Common Stock Dividends Paid | **(72,234)** | (69,648) | (61,904) |
| Proceeds from Stock Options Exercised | **3,831** | 3,570 | 8,115 |
| Proceeds from Common Stock Issuance | **464** | — | — |
| Proceeds from Issuance of Long-Term Debt | **—** | 149,513 | 340,285 |
| Repayments of Long-Term Debt | **—** | (9,341) | (252,125) |
| Other, net | **818** | (324) | (1,431) |
| **Net Cash Flows—Financing Activities** | **(135,742)** | (37,682) | (1,441) |
| **Net Increase (Decrease) in Cash and Cash Equivalents** | **(49,040)** | 47,528 | 8,791 |
| **Cash and Cash Equivalents, Beginning of Year** | **123,918** | 76,390 | 67,599 |
| **Cash and Cash Equivalents, End of Year** | **$ 74,878** | $ 123,918 | $ 76,390 |

See Note 14 for supplemental cash flow information.

See Notes to Consolidated Financial Statements.

**UNS ENERGY CORPORATION**
**CONSOLIDATED BALANCE SHEETS**

| | December 31, | |
|---|---|---|
| | 2013 | 2012 |
| | Thousands of Dollars | |
| **ASSETS** | | |
| **Utility Plant** | | |
| Plant in Service | $ **5,192,122** | $ 5,005,768 |
| Utility Plant Under Capital Leases | **637,957** | 582,669 |
| Construction Work in Progress | **201,959** | 128,621 |
| **Total Utility Plant** | **6,032,038** | 5,717,058 |
| Less Accumulated Depreciation and Amortization | **(1,982,524)** | (1,921,733) |
| Less Accumulated Amortization of Capital Lease Assets | **(514,677)** | (494,962) |
| **Total Utility Plant—Net** | **3,534,837** | 3,300,363 |
| **Investments and Other Property** | | |
| Investments in Lease Equity | **36,194** | 36,339 |
| Other | **34,971** | 36,537 |
| **Total Investments and Other Property** | **71,165** | 72,876 |
| **Current Assets** | | |
| Cash and Cash Equivalents | **74,878** | 123,918 |
| Accounts Receivable—Customer | **104,596** | 93,742 |
| Unbilled Accounts Receivable | **52,403** | 53,568 |
| Allowance for Doubtful Accounts | **(6,833)** | (6,545) |
| Materials and Supplies | **88,085** | 93,322 |
| Deferred Income Taxes—Current | **66,906** | 34,260 |
| Regulatory Assets—Current | **52,763** | 51,619 |
| Fuel Inventory | **44,317** | 62,019 |
| Derivative Instruments | **5,629** | 3,165 |
| Investments in Lease Debt | **—** | 9,118 |
| Other | **15,354** | 33,567 |
| **Total Current Assets** | **498,098** | 551,753 |
| **Regulatory and Other Assets** | | |
| Regulatory Assets—Noncurrent | **150,584** | 191,077 |
| Derivative Instruments | **1,180** | 3,801 |
| Other Assets | **24,430** | 20,559 |
| **Total Regulatory and Other Assets** | **176,194** | 215,437 |
| **Total Assets** | $ **4,280,294** | $ 4,140,429 |

See Notes to Consolidated Financial Statements.

**(Continued)**

**UNS ENERGY CORPORATION**
**CONSOLIDATED BALANCE SHEETS**

| | December 31, | |
|---|---|---|
| | 2013 | 2012 |
| | Thousands of Dollars | |
| **CAPITALIZATION AND OTHER LIABILITIES** | | |
| **Capitalization** | | |
| Common Stock Equity | **$ 1,130,784** | $ 1,065,465 |
| Capital Lease Obligations | **131,370** | 262,138 |
| Long-Term Debt | **1,507,070** | 1,498,442 |
| **Total Capitalization** | **2,769,224** | 2,826,045 |
| **Current Liabilities** | | |
| Current Obligations Under Capital Leases | **186,056** | 90,583 |
| Borrowings Under Revolving Credit Facilities | **22,000** | — |
| Accounts Payable—Trade | **117,503** | 107,740 |
| Regulatory Liabilities—Current | **53,935** | 43,516 |
| Accrued Taxes Other than Income Taxes | **43,880** | 41,939 |
| Customer Deposits | **30,671** | 34,048 |
| Accrued Employee Expenses | **28,148** | 24,094 |
| Accrued Interest | **27,786** | 31,950 |
| Derivative Instruments | **7,534** | 14,742 |
| Other | **17,775** | 10,517 |
| **Total Current Liabilities** | **535,288** | 399,129 |
| **Deferred Credits and Other Liabilities** | | |
| Deferred Income Taxes—Noncurrent | **488,887** | 364,756 |
| Regulatory Liabilities—Noncurrent | **302,482** | 279,111 |
| Pension and Other Retiree Benefits | **90,923** | 159,401 |
| Derivative Instruments | **7,100** | 12,709 |
| Other | **86,390** | 99,278 |
| **Total Deferred Credits and Other Liabilities** | **975,782** | 915,255 |
| **Commitments, Contingencies, and Environmental Matters (Note 7)** | | |
| **Total Capitalization and Other Liabilities** | **$ 4,280,294** | $ 4,140,429 |

See Notes to Consolidated Financial Statements.

**(Concluded)**

## UNS ENERGY CORPORATION
## CONSOLIDATED STATEMENTS OF CAPITALIZATION

| | | | December 31, | |
|---|---|---|---|---|
| | | | 2013 | 2012 |
| | | | Thousands of Dollars | |
| **COMMON STOCK EQUITY** | | | | |
| Common Stock-No Par Value | | | **$ 889,301** | $ 882,138 |
| | **2013** | **2012** | | |
| Shares Authorized | **75,000,000** | 75,000,000 | | |
| Shares Outstanding | **41,538,343** | 41,343,851 | | |
| Retained Earnings | | | **247,532** | 193,117 |
| Accumulated Other Comprehensive Loss | | | **(6,049)** | (9,790) |
| **Total Common Stock Equity** | | | **1,130,784** | 1,065,465 |
| **PREFERRED STOCK** | | | | |
| No Par Value, 1,000,000 Shares Authorized, None Outstanding | | | **—** | — |
| **CAPITAL LEASE OBLIGATIONS** | | | | |
| Springerville Unit 1 | | | **192,871** | 196,843 |
| Springerville Coal Handling Facilities | | | **27,878** | 48,038 |
| Springerville Common Facilities | | | **96,677** | 107,840 |
| Total Capital Lease Obligations | | | **317,426** | 352,721 |
| Less Current Maturities | | | **(186,056)** | (90,583) |
| **Total Long-Term Capital Lease Obligations** | | | **131,370** | 262,138 |
| **LONG-TERM DEBT** | | | | |
| | **Maturity** | **Interest Rate** | | |
| UNS Energy: | | | | |
| Credit Agreement | 2016 | Variable | **54,000** | 45,000 |
| Tucson Electric Power Company: | | | | |
| Variable Rate Bonds | 2016 - 2032 | Variable | **214,802** | 215,300 |
| Fixed Rate Bonds | 2020 - 2040 | 3.85% – 5.75% | **1,008,268** | 1,008,142 |
| UNS Electric and UNS Gas: | | | | |
| Senior Notes | 2015 – 2026 | 5.39% – 7.10% | **200,000** | 200,000 |
| UNS Electric: | | | | |
| Term Loan | 2015 | Variable | **30,000** | 30,000 |
| **Total Long-Term Debt** | | | **1,507,070** | 1,498,442 |
| **Total Capitalization** | | | **$ 2,769,224** | $ 2,826,045 |

See Notes to Consolidated Financial Statements.

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

| | Common Shares Outstanding | Common Stock | Retained Earnings | Accumulated Other Comprehensive Loss | Total Stockholders' Equity |
|---|---|---|---|---|---|
| | Thousands of Shares | | Thousands of Dollars | | |
| **Balances at December 31, 2010** | **36,542** | **$ 715,687** | **$ 124,838** | **$ (9,769)** | **$ 830,756** |
| Net Income | | | 109,975 | | 109,975 |
| Other Comprehensive Loss, net of tax | | | | (315) | (315) |
| Dividends Declared | | | (62,158) | | (62,158) |
| Shares Issued for Stock Options | 319 | 8,176 | | | 8,176 |
| Shares Issued under Performance Share Awards | 57 | — | | | — |
| Share-based Compensation | | 2,040 | | | 2,040 |
| **Balances at December 31, 2011** | **36,918** | **725,903** | **172,655** | **(10,084)** | **888,474** |
| Net Income | | | 90,919 | | 90,919 |
| Other Comprehensive Income, net of tax | | | | 294 | 294 |
| Dividends Declared | | | (70,457) | | (70,457) |
| Shares Issued on Conversion of Notes and Related Tax Effect | 4,262 | 149,805 | | | 149,805 |
| Shares Issued for Stock Options | 133 | 3,511 | | | 3,511 |
| Shares Issued under Performance Share Awards | 31 | — | | | — |
| Share-based Compensation | | 2,919 | | | 2,919 |
| **Balances at December 31, 2012** | **41,344** | **882,138** | **193,117** | **(9,790)** | **1,065,465** |
| Net Income | | | 127,478 | | 127,478 |
| Other Comprehensive Income, net of tax | | | | 3,741 | 3,741 |
| Dividends Declared | | | (73,063) | | (73,063) |
| Shares Issued under Dividend Reinvestment Plan | 10 | 464 | | | 464 |
| Shares Issued for Stock Options | 127 | 3,831 | | | 3,831 |
| Shares Issued under Performance Share Awards | 57 | — | | | — |
| Share-based Compensation | | 2,868 | | | 2,868 |
| **Balances at December 31, 2013** | **41,538** | **$ 889,301** | **$ 247,532** | **$ (6,049)** | **$ 1,130,784** |

We describe limitations on our ability to pay dividends in Note 13.

See Notes to Consolidated Financial Statements.

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

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2013 | 2012 | 2011 |
| | | Thousands of Dollars | |
| **Operating Revenues** | | | |
| Electric Retail Sales | **$ 934,357** | $ 915,879 | $ 903,930 |
| Electric Wholesale Sales | **132,500** | 111,194 | 129,861 |
| Other Revenues | **129,833** | 134,587 | 122,595 |
| **Total Operating Revenues** | **1,196,690** | 1,161,660 | 1,156,386 |
| **Operating Expenses** | | | |
| Fuel | **325,903** | 318,901 | 318,268 |
| Purchased Power | **112,452** | 80,137 | 105,766 |
| Transmission and Other PPFAC Recoverable Costs | **12,233** | 5,722 | (1,435) |
| Increase (Decrease) to Reflect PPFAC Recovery Treatment | **(12,458)** | 31,113 | (6,165) |
| **Total Fuel and Purchased Energy** | **438,130** | 435,873 | 416,434 |
| Operations and Maintenance | **335,321** | 334,553 | 330,801 |
| Depreciation | **118,076** | 110,931 | 104,894 |
| Amortization | **31,294** | 39,493 | 34,650 |
| Taxes Other Than Income Taxes | **43,498** | 40,323 | 40,199 |
| **Total Operating Expenses** | **966,319** | 961,173 | 926,978 |
| **Operating Income** | **230,371** | 200,487 | 229,408 |
| **Other Income (Deductions)** | | | |
| Interest Income | **120** | 136 | 3,567 |
| Other Income | **5,770** | 3,953 | 5,364 |
| Other Expense | **(10,715)** | (13,574) | (12,064) |
| Appreciation in Fair Value of Investments | **2,833** | 1,892 | 329 |
| **Total Other Income (Deductions)** | **(1,992)** | (7,593) | (2,804) |
| **Interest Expense** | | | |
| Long-Term Debt | **56,378** | 55,038 | 49,858 |
| Capital Leases | **25,140** | 33,613 | 40,358 |
| Other Interest Expense | **87** | 1,446 | 1,127 |
| Interest Capitalized | **(2,554)** | (1,782) | (2,073) |
| **Total Interest Expense** | **79,051** | 88,315 | 89,270 |
| **Income Before Income Taxes** | **149,328** | 104,579 | 137,334 |
| Income Tax Expense | **47,986** | 39,109 | 52,000 |
| **Net Income** | **$ 101,342** | $ 65,470 | $ 85,334 |

See Notes to Consolidated Financial Statements.

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

| | Years Ended December 31, | | |
|---|---|---|---|
| | **2013** | **2012** | **2011** |
| | | Thousands of Dollars | |
| **Comprehensive Income** | | | |
| Net Income | **$ 101,342** | $ 65,470 | $ 85,334 |
| **Other Comprehensive Income (Loss)** | | | |
| Net Changes in Fair Value of Cash Flow Hedges, net of income tax (expense) benefit of $(1,793), $(887), and $941 | **2,738** | 1,354 | (1,433) |
| SERP Benefit Amortization, net of income tax (expense) benefit of $(572), $608, and $(804) | **916** | (840) | 1,158 |
| **Total Other Comprehensive Income (Loss), Net of Tax** | **3,654** | 514 | (275) |
| **Total Comprehensive Income** | **$ 104,996** | $ 65,984 | $ 85,059 |

See Notes to Consolidated Financial Statements.

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

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2013 | 2012 | 2011 |
| | | Thousands of Dollars | |
| **Cash Flows from Operating Activities** | | | |
| Cash Receipts from Electric Retail Sales | **$ 1,020,903** | $ 1,006,926 | $ 963,247 |
| Cash Receipts from Electric Wholesale Sales | **146,880** | 124,594 | 152,618 |
| Cash Receipts from Operating Springerville Units 3 & 4 | **114,258** | 107,927 | 104,754 |
| Reimbursement of Affiliate Charges | **23,468** | 20,926 | 18,448 |
| Cash Receipts from Gas Wholesale Sales | **3,271** | 4,652 | 11,825 |
| Interest Received | **509** | 2,025 | 5,367 |
| Income Tax Refunds Received | **77** | 493 | 7,492 |
| Other Cash Receipts | **25,079** | 18,850 | 19,611 |
| Fuel Costs Paid | **(280,639)** | (313,742) | (271,975) |
| Payment of Operations and Maintenance Costs | **(253,054)** | (282,752) | (287,615) |
| Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized | **(144,849)** | (147,859) | (139,728) |
| Purchased Power Costs Paid | **(115,008)** | (81,328) | (117,224) |
| Wages Paid, Net of Amounts Capitalized | **(110,995)** | (104,955) | (100,942) |
| Interest Paid, Net of Amounts Capitalized | **(52,589)** | (52,125) | (45,433) |
| Capital Lease Interest Paid | **(22,553)** | (28,786) | (32,103) |
| Income Taxes Paid | **—** | (1,796) | (2,346) |
| Wholesale Gas Cost Paid | **—** | — | (11,822) |
| Other Cash Payments | **(8,567)** | (5,131) | (5,880) |
| **Net Cash Flows—Operating Activities** | **346,191** | 267,919 | 268,294 |
| **Cash Flows from Investing Activities** | | | |
| Capital Expenditures | **(252,848)** | (252,782) | (351,890) |
| Purchase of Intangibles—Renewable Energy Credits | **(23,280)** | (8,889) | (5,111) |
| Return of Investments in Springerville Lease Debt | **9,104** | 19,278 | 38,353 |
| Change in Restricted Cash | **4,134** | (1,445) | — |
| Other, net | **3,228** | 15,957 | 6,637 |
| **Net Cash Flows—Investing Activities** | **(259,662)** | (227,881) | (312,011) |
| **Cash Flows from Financing Activities** | | | |
| Proceeds from Borrowings Under Revolving Credit Facility | **78,000** | 189,000 | 220,000 |
| Repayments of Borrowings Under Revolving Credit Facility | **(78,000)** | (199,000) | (210,000) |
| Payments of Capital Lease Obligations | **(99,621)** | (89,452) | (74,343) |
| Dividends Paid to UNS Energy | **(40,000)** | (30,000) | — |
| Proceeds from Issuance of Long-Term Debt | **—** | 149,513 | 260,285 |
| Repayments of Long-Term Debt | **—** | (6,535) | (172,460) |
| Equity Investment from UNS Energy | **—** | — | 30,000 |
| Other, net | **(1,316)** | (1,539) | (2,030) |
| **Net Cash Flows—Financing Activities** | **(140,937)** | 11,987 | 51,452 |
| **Net Increase (Decrease) in Cash and Cash Equivalents** | **(54,408)** | 52,025 | 7,735 |
| **Cash and Cash Equivalents, Beginning of Year** | **79,743** | 27,718 | 19,983 |
| **Cash and Cash Equivalents, End of Year** | **$ 25,335** | $ 79,743 | $ 27,718 |

See Note 14 for supplemental cash flow information.

See Notes to Consolidated Financial Statements.

## TUCSON ELECTRIC POWER COMPANY
## CONSOLIDATED BALANCE SHEETS

| | December 31, | |
|---|---|---|
| | 2013 | 2012 |
| | Thousands of Dollars | |
| **ASSETS** | | |
| **Utility Plant** | | |
| Plant in Service | **$ 4,467,667** | $ 4,348,041 |
| Utility Plant Under Capital Leases | **637,957** | 582,669 |
| Construction Work in Progress | **180,485** | 98,460 |
| **Total Utility Plant** | **5,286,109** | 5,029,170 |
| Less Accumulated Depreciation and Amortization | **(1,826,977)** | (1,783,787) |
| Less Accumulated Amortization of Capital Lease Assets | **(514,677)** | (494,962) |
| **Total Utility Plant—Net** | **2,944,455** | 2,750,421 |
| **Investments and Other Property** | | |
| Investments in Lease Equity | **36,194** | 36,339 |
| Other | **33,488** | 35,091 |
| **Total Investments and Other Property** | **69,682** | 71,430 |
| **Current Assets** | | |
| Cash and Cash Equivalents | **25,335** | 79,743 |
| Accounts Receivable—Customer | **80,211** | 71,813 |
| Unbilled Accounts Receivable | **34,369** | 33,782 |
| Allowance for Doubtful Accounts | **(4,825)** | (4,598) |
| Accounts Receivable—Due from Affiliates | **6,064** | 5,720 |
| Materials and Supplies | **75,200** | 80,377 |
| Deferred Income Taxes—Current | **70,722** | 37,212 |
| Fuel Inventory | **44,027** | 61,737 |
| Regulatory Assets—Current | **42,555** | 34,345 |
| Derivative Instruments | **2,137** | 2,230 |
| Investments in Lease Debt | **—** | 9,118 |
| Other | **12,923** | 32,163 |
| **Total Current Assets** | **388,718** | 443,642 |
| **Regulatory and Other Assets** | | |
| Regulatory Assets—Noncurrent | **141,030** | 178,330 |
| Derivative Instruments | **167** | 1,354 |
| Other Assets | **19,233** | 15,869 |
| **Total Regulatory and Other Assets** | **160,430** | 195,553 |
| **Total Assets** | **$ 3,563,285** | $ 3,461,046 |

See Notes to Consolidated Financial Statements.

**(Continued)**

**TUCSON ELECTRIC POWER COMPANY**
**CONSOLIDATED BALANCE SHEETS**

| | December 31, | |
|---|---|---|
| | 2013 | 2012 |
| | Thousands of Dollars | |
| **CAPITALIZATION AND OTHER LIABILITIES** | | |
| **Capitalization** | | |
| Common Stock Equity | **$ 925,923** | $ 860,927 |
| Capital Lease Obligations | **131,370** | 262,138 |
| Long-Term Debt | **1,223,070** | 1,223,442 |
| **Total Capitalization** | **2,280,363** | 2,346,507 |
| **Current Liabilities** | | |
| Current Obligations Under Capital Leases | **186,056** | 90,583 |
| Accounts Payable—Trade | **88,556** | 82,122 |
| Accounts Payable—Due to Affiliates | **9,153** | 3,134 |
| Accrued Taxes Other than Income Taxes | **34,485** | 33,060 |
| Accrued Employee Expenses | **24,454** | 20,715 |
| Regulatory Liabilities—Current | **23,701** | 20,822 |
| Accrued Interest | **22,785** | 26,965 |
| Customer Deposits | **21,354** | 24,846 |
| Derivative Instruments | **5,531** | 4,899 |
| Other | **9,244** | 7,085 |
| **Total Current Liabilities** | **425,319** | 314,231 |
| **Deferred Credits and Other Liabilities** | | |
| Deferred Income Taxes—Noncurrent | **428,103** | 319,216 |
| Regulatory Liabilities—Noncurrent | **263,270** | 241,189 |
| Pension and Other Retiree Benefits | **84,936** | 149,718 |
| Derivative Instruments | **5,161** | 10,565 |
| Other | **76,133** | 79,620 |
| **Total Deferred Credits and Other Liabilities** | **857,603** | 800,308 |
| **Commitments, Contingencies, and Environmental Matters (Note 7)** | | |
| **Total Capitalization and Other Liabilities** | **$ 3,563,285** | $ 3,461,046 |

See Notes to Consolidated Financial Statements.

**(Concluded)**

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

| | | | December 31, 2013 | December 31, 2012 |
|---|---|---|---|---|
| | | | Thousands of Dollars | |
| **COMMON STOCK EQUITY** | | | | |
| Common Stock-No Par Value | | | **$ 888,971** | $ 888,971 |
| | **2013** | **2012** | | |
| Shares Authorized | **75,000,000** | 75,000,000 | | |
| Shares Outstanding | **32,139,434** | 32,139,434 | | |
| Capital Stock Expense | | | **(6,357)** | (6,357) |
| Accumulated Earnings (Deficit) | | | **49,185** | (12,157) |
| Accumulated Other Comprehensive Loss | | | **(5,876)** | (9,530) |
| **Total Common Stock Equity** | | | **925,923** | 860,927 |
| **PREFERRED STOCK** | | | | |
| No Par Value, 1,000,000 Shares Authorized, None Outstanding | | | **—** | — |
| **CAPITAL LEASE OBLIGATIONS** | | | | |
| Springerville Unit 1 | | | **192,871** | 196,843 |
| Springerville Coal Handling Facilities | | | **27,878** | 48,038 |
| Springerville Common Facilities | | | **96,677** | 107,840 |
| Total Capital Lease Obligations | | | **317,426** | 352,721 |
| Less Current Maturities | | | **(186,056)** | (90,583) |
| **Total Long-Term Capital Lease Obligations** | | | **131,370** | 262,138 |
| **LONG-TERM DEBT** | | | | |
| | **Maturity** | **Interest Rate** | | |
| Variable Rate Bonds | 2016 - 2032 | Variable | **214,802** | 215,300 |
| Fixed Rate Bonds | 2020 - 2040 | 3.85% – 5.75% | **1,008,268** | 1,008,142 |
| **Total Long-Term Debt** | | | **1,223,070** | 1,223,442 |
| **Total Capitalization** | | | **$ 2,280,363** | $ 2,346,507 |

See Notes to Consolidated Financial Statements.

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

| | Common Stock | Capital Stock Expense | Accumulated Earnings (Deficit) | Accumulated Other Comprehensive Loss | Total Stockholder's Equity |
|---|---|---|---|---|---|
| | | | Thousands of Dollars | | |
| **Balances at December 31, 2010** | **$ 858,971** | **$ (6,357)** | **$ (132,961)** | **$ (9,769)** | **$ 709,884** |
| Net Income | | | 85,334 | | 85,334 |
| Other Comprehensive Loss, net of tax | | | | (275) | (275) |
| Capital Contribution from UNS Energy | 30,000 | | | | 30,000 |
| **Balances at December 31, 2011** | **888,971** | **(6,357)** | **(47,627)** | **(10,044)** | **824,943** |
| Net Income | | | 65,470 | | 65,470 |
| Other Comprehensive Income, net of tax | | | | 514 | 514 |
| Dividends Declared | | | (30,000) | | (30,000) |
| **Balances at December 31, 2012** | **888,971** | **(6,357)** | **(12,157)** | **(9,530)** | **860,927** |
| Net Income | | | 101,342 | | 101,342 |
| Other Comprehensive Income, net of tax | | | | 3,654 | 3,654 |
| Dividends Declared | | | (40,000) | | (40,000) |
| **Balances at December 31, 2013** | **$ 888,971** | **$ (6,357)** | **$ 49,185** | **$ (5,876)** | **$ 925,923** |

We describe limitations on our ability to pay dividends in Note 13.

See Notes to Consolidated Financial Statements.

## NOTE 1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### NATURE OF OPERATIONS

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

TEP is a regulated utility and UNS Energy's largest operating subsidiary, representing approximately 83% of UNS Energy's total assets as of December 31, 2013. TEP generates, transmits and distributes electricity to approximately 413,000 retail electric customers in a 1,155 square mile area in southeastern Arizona. TEP also sells electricity to other utilities and power marketing entities, located primarily in the western United States. In addition, TEP operates Springerville Generating Station (Springerville) Unit 3 on behalf of Tri-State Generation and Transmission Association, Inc. (Tri-State) and Springerville Unit 4 on behalf of Salt River Project Agriculture Improvement and Power District (SRP).

UES wholly-owns two regulated utilities: UNS Electric, Inc. (UNS Electric) and UNS Gas, Inc. (UNS Gas). UNS Electric is a regulated utility, which generates, transmits and distributes electricity to approximately 93,000 retail customers in Mohave and Santa Cruz counties in Arizona. UNS Gas is a regulated gas distribution company, which services approximately 150,000 retail customers in Mohave, Yavapai, Coconino, Navajo, and Santa Cruz counties in Arizona.

UED and Millennium's investments in unregulated businesses represent less than 1% of UNS Energy's assets as of December 31, 2013.

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

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

See Note 2 for information regarding a pending merger with Fortis, Inc.

### REVISION OF BALANCE SHEETS AND STATEMENTS OF CAPITALIZATION AS OF DECEMBER 31, 2013

UNS Energy and TEP revised their December 31, 2013 balance sheets and statements of capitalization to correct an immaterial error in the classification of capital lease obligations and related deferred income taxes. The correction increased current capital lease obligations and decreased noncurrent capital lease obligations by $18 million and increased current deferred tax assets and noncurrent deferred tax liabilities by $7 million. The notes that follow have been updated for this revision.

### BASIS OF PRESENTATION

UNS Energy's consolidated financial statements and disclosures are presented in accordance with generally accepted accounting principles (GAAP) in the United States which includes specific accounting guidance for regulated operations. See Note 3. The consolidated financial statements include the accounts of UNS Energy and all of its subsidiaries. In the consolidation process, accounts of the parent and subsidiaries are combined, and intercompany balances and transactions are eliminated. Intercompany profits on transactions between regulated entities are not eliminated if recovery from ratepayers is probable. See Note 4. TEP jointly owns several generating stations and transmission facilities with non-affiliated entities. TEP's proportionate share of jointly owned facilities is recorded as Utility Plant on the consolidated balance sheets, and our proportionate share of the operating costs associated with these facilities is included in the consolidated statements of income. See Note 5.

### USE OF ACCOUNTING ESTIMATES

Management uses estimates and assumptions when preparing financial statements under GAAP. These estimates and assumptions affect:

- Assets and liabilities on our balance sheets at the dates of the financial statements;
- Our disclosures about contingent assets and liabilities at the dates of the financial statements; and
- Our revenues and expenses in our income statements during the periods presented.

Because these estimates involve judgments based upon our evaluation of relevant facts and circumstances, actual results may differ from the estimates.

## ACCOUNTING FOR REGULATED OPERATIONS

We apply accounting standards that recognize the economic effects of rate regulation. As a result, we capitalize certain costs that would be recorded as expense or in Accumulated Other Comprehensive Income (AOCI) by unregulated companies. Regulatory assets represent incurred costs that have been deferred because they are probable of future recovery in the rates charged to retail customers or to wholesale customers through FERC-approved transmission tariffs. Regulatory liabilities generally represent expected future costs that have already been collected from customers or items that are expected to be returned to customers through future billing reductions.

Estimates of recovering deferred costs and returning deferred credits are based on specific ratemaking decisions or precedent for each item. Regulatory assets and liabilities are amortized consistent with the treatment in the rate setting process. We evaluate regulatory assets each period and believe recovery is probable. If future recovery of costs ceases to be probable, the assets would be written off as a charge to current period earnings or AOCI. See Note 3.

TEP, UNS Electric, and UNS Gas apply regulatory accounting as the following conditions exist:

- An independent regulator sets rates;
- The regulator sets the rates to recover the specific enterprise's costs of providing service; and
- Rates are set at levels that will recover the entity's costs and can be charged to and collected from customers.

## RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

In 2013, we adopted authoritative guidance that:

- Requires disclosure related to offsetting derivative assets and derivative liabilities in accordance with GAAP. See Note 15.
- Requires additional disclosures for amounts reclassified out of Accumulated Other Comprehensive Income (AOCI) by component. See Note 16.

## CASH AND CASH EQUIVALENTS

We consider all highly liquid investments with a remaining maturity of three months or less at acquisition to be cash equivalents.

## RESTRICTED CASH

Cash balances that are restricted regarding withdrawal or usage based on contractual or regulatory considerations are reported in Investments and Other Property—Other on the balance sheets. Restricted cash was $2 million at December 31, 2013 and $7 million at December 31, 2012.

## UTILITY PLANT

Utility Plant includes the business property and equipment that supports electric and gas services, consisting primarily of generation, transmission, and distribution facilities. We report utility plant at original cost. Original cost includes materials and labor, contractor services, construction overhead (when applicable), and an Allowance for Funds Used During Construction (AFUDC), less contributions in aid of construction.

We record the cost of repairs and maintenance, including planned major overhauls, to Operations and Maintenance (O&M) expense in the income statements as costs are incurred.

When a unit of regulated property is retired, we reduce accumulated depreciation by the original cost plus removal costs less any salvage value. There is no income statement impact.

### AFUDC and Capitalized Interest

AFUDC reflects the cost of debt and equity funds used to finance construction and is capitalized as part of the cost of regulated utility plant. AFUDC amounts are capitalized and amortized through depreciation expense as a recoverable cost in Retail Rates. For operations that do not apply regulatory accounting, we capitalize interest related only to debt as a cost of construction. The capitalized interest that relates to debt is recorded as a reduction in Interest Expense in the income statements. The capitalized cost for equity funds is recorded as Other Income in the income statements.

The average AFUDC rates on regulated construction expenditures are included in the table below:

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| TEP | 7.38% | 7.22% | 6.72% |
| UNS Electric | 8.07% | 7.89% | 8.18% |
| UNS Gas | 7.89% | 7.95% | 8.32% |

UNS Energy did not capitalize interest related to non-regulated construction activity in 2013 or 2012. UNS Energy capitalized interest on non-regulated construction activity at a rate of 3.30% for 2011.

### Depreciation

We compute depreciation for owned utility plant on a group method straight-line basis at depreciation rates based on the economic lives of the assets. See Note 3 and Note 5. The Arizona Corporation Commission (ACC) approves depreciation rates for all generation and distribution assets. Transmission assets are subject to the jurisdiction of the Federal Energy Regulatory Commission (FERC). Depreciation rates are based on average useful lives and include estimates for salvage value and removal costs. Below are the summarized average annual depreciation rates for all utility plant:

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| TEP | 3.16% | 3.22% | 3.14% |
| UNS Electric | 3.94% | 3.99% | 4.02% |
| UNS Gas | 2.63% | 2.69% | 2.84% |

### TEP Utility Plant Under Capital Leases

TEP financed the following generation assets with capital leases: Springerville Unit 1; facilities at Springerville used in common with Springerville Unit 1 and Unit 2 (Springerville Common Facilities); and the Springerville Coal Handling Facilities. The capital lease expense incurred consists of Amortization Expense (see Note 5) and Interest Expense—Capital Leases. The lease terms are described in Note 6.

### Computer Software Costs

We capitalize costs incurred to purchase and develop internal use computer software 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.

## INVESTMENTS IN LEASE DEBT AND EQUITY

TEP held an investment in lease debt relating to Springerville Unit 1 through its maturity date in January 2013 and recorded this investment at amortized cost and recognized interest income. TEP holds a 14% equity interest in Springerville Unit 1 and a 7% interest in certain Springerville Common Facilities (Springerville Unit 1 Leases). The fair value of these investments is described in Note 15. 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 the equity holders.

TEP accounts for its equity interest in the Springerville Unit 1 Lease trust using the equity method.

## ASSET RETIREMENT OBLIGATIONS

TEP and UNS Electric have identified legal Asset Retirement Obligations (AROs) related to the retirement of certain generation assets. Additionally, TEP and UNS Electric incurred AROs related to their photovoltaic assets as a result of entering into various ground leases. We record a liability for a legal ARO in the period in which it is incurred if it can be reasonably

estimated. When a new obligation is recorded, we capitalize the cost of the liability by increasing the carrying amount of the related long-lived asset. We record the increase in the liability due to the passage of time by recognizing accretion expense in O&M expense, and depreciate the capitalized cost over the useful life of the related asset or when applicable, the terms of the lease subject to ARO requirements. Beginning July 1, 2013, TEP began deferring costs associated with the majority of its legal AROs as regulatory assets because new depreciation rates approved in the 2013 TEP Rate Order include these costs.

Depreciation rates for all of our utilities also include a component for estimated future removal costs that have not been identified as legal obligations. We recover those amounts in the rates charged to retail customers and have recorded an obligation for estimated costs of removal as regulatory liabilities.

**EVALUATION OF ASSETS FOR IMPAIRMENT**

We evaluate long-lived assets and investments for impairment whenever events or circumstances indicate the carrying value of the assets may be impaired. If expected future cash flows (without discounting) are less than the carrying value of the asset, an impairment loss is recognized if the impairment is other-than-temporary and the loss is not recoverable through rates.

**DEFERRED FINANCING COSTS**

We defer the costs to issue debt and amortize such costs to interest expense 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, regulatory fees, and printing costs.

We defer and amortize the gains and losses on reacquired debt associated with regulated operations to interest expense over the remaining life of the original debt.

**OPERATING REVENUES**

We recognize revenues related to the sale of energy when services or commodities are delivered to customers. The billing of electricity and gas sales to retail customers is based on the reading of their meters, which occurs on a systematic basis throughout the month. Operating revenues include an estimate for unbilled revenues from service that has been provided but not billed by the end of an accounting period. At the end of the month, amounts of energy delivered since the last meter reading are estimated and the corresponding unbilled revenue is calculated using average customer Retail Rates.

For purchased power and wholesale sales contracts that are not settled with energy, TEP and UNS Electric net the sales contracts with the purchase power contracts and reflect the net amount as Electric Wholesale Sales. The corresponding cash receipts are recorded in the statement of cash flows as Cash Receipts from Electric Wholesale Sales, while cash payments are recorded as Purchased Energy/Power Costs Paid.

TEP recognizes monthly management fees in Other Revenues as the operator of Springerville Unit 3 on behalf of Tri-State and Springerville Unit 4 on behalf of SRP. Additionally, Other Revenues include reimbursements from Tri-State and SRP for various operating expenses at Springerville and for the use of the Springerville Common Facilities and the Springerville Coal Handling Facilities. The offsetting expenses are recorded in the respective line items of the income statements based on the nature of services provided. As the operating agent for Tri-State and SRP, TEP may earn performance incentives based on unit availability which are recognized in Other Revenues in the period earned.

The ACC has authorized mechanisms for Lost Fixed Cost Recovery (LFCR) associated with energy sales that no longer occur due to EE Standards and distributed generation. We recognize revenues in the period that verifiable energy savings occur. Revenue recognition related to the LFCR creates a regulatory asset until such time as the revenue is collected.

**ALLOWANCE FOR DOUBTFUL ACCOUNTS**

We record an Allowance for Doubtful Accounts to reduce accounts receivable for amounts estimated to be uncollectible. The allowance is determined based on historical bad debt patterns, retail sales, and economic conditions.

**INVENTORY**

We value materials, supplies and fuel inventory at the lower of weighted average cost or market, unless evidence indicates that the weighted average cost (even if in excess of market) will be recovered in retail rates. We capitalize handling and procurement costs (such as labor, overhead costs, and transportation costs) as part of the cost of the inventory. Materials and Supplies consist of generation, transmission, and distribution construction and repair materials.

**FUEL AND PURCHASED ENERGY COST RECOVERY MECHANISMS**

**TEP and UNS Electric Purchased Power and Fuel Adjustment Clause**

TEP and UNS Electric recover actual fuel, purchased power and transmission costs incurred to provide electric service to retail customers through base fuel rates and a Purchased Power and Fuel Adjustment Clause (PPFAC); the ACC periodically adjusts the PPFAC rate at which TEP and UNS Electric recover these costs. The difference between costs recovered through rates and actual fuel, purchased power and transmission costs prudently incurred to provide retail electric service is deferred. Cost over-recoveries are deferred as regulatory liabilities and cost under-recoveries are deferred as regulatory assets. See Note 3.

**UNS Gas Purchased Gas Adjustor**

UNS Gas recovers actual gas costs incurred through a Purchased Gas Adjustor (PGA) mechanism that adjusts monthly. Gas cost over-recoveries are deferred as regulatory liabilities and under-recoveries are deferred as regulatory assets. See Note 3.

**RENEWABLE ENERGY and ENERGY EFFICIENCY PROGRAMS**

The ACC's Renewable Energy Standard (RES) requires TEP and UNS Electric to increase their use of renewable energy each year until it represents at least 15% of their total annual retail energy requirements in 2025. The utilities must file annual RES implementation plans for review and approval by the ACC. The approved cost of carrying out those plans is recovered from retail customers through the RES surcharge. The ACC has also approved recovery of operating costs, depreciation, property taxes, and a return on investments in company-owned solar projects through the RES tariff until such costs are reflected in retail customer rates.

TEP, UNS Electric, and UNS Gas are required to implement cost-effective Demand-Side Management (DSM) programs to comply with the ACC's Energy Efficiency (EE) Standards. The EE Standards provide for a DSM surcharge to recover, from retail customers, the costs to implement DSM programs. The Electric EE Standards require increasing annual targeted retail kWh savings equal to22% by 2020. The Gas EE Standards require increasing annual targeted retail therm sales equal to 6% by 2020.

Any RES or DSM surcharge collections above or below the costs incurred to implement the plans are deferred and reflected in the financial statements as a regulatory asset or liability. TEP and UNS Electric recognize RES and DSM surcharge revenue in Electric Retail Sales in amounts necessary to offset recognized qualifying expenditures. Similarly, UNS Gas recognizes DSM surcharge revenue in Gas Retail Sales.

**RENEWABLE ENERGY CREDITS**

The ACC measures compliance with the RES requirements through Renewable Energy Credits (RECs). A REC represents one kWh generated from renewable resources. When TEP or UNS Electric purchases renewable energy, the premium paid above the market cost of conventional power equals the REC cost recoverable through the RES surcharge. As described above, the market cost of conventional power is recoverable through the PPFAC.

When RECs are purchased, TEP and UNS Electric record the cost of the RECs (an indefinite-lived intangible asset) as Other Assets, and a corresponding regulatory liability, to reflect the obligation to use the RECs for future RES compliance. When RECs are reported to the ACC for compliance with RES requirements, TEP and UNS Electric recognize Purchased Power expense and Other Revenues in an equal amount. See Note 3.

**INCOME TAXES**

Due to the difference between GAAP and income tax laws, many transactions are treated differently for income tax purposes than for financial statement presentation purposes. Temporary differences are accounted for by recording deferred income tax assets and liabilities on our balance sheets. These assets and liabilities are recorded using income tax rates expected to be in effect when the deferred tax assets and liabilities are realized or settled. We reduce deferred tax assets by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or the entire deferred income tax asset will not be realized.

Tax benefits are recognized 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, assuming full knowledge of the position and all relevant facts. Interest expense accruals relating to income tax obligations are recorded in Other Interest Expense.

Prior to 1990, TEP flowed through to ratepayers certain accelerated tax benefits related to utility plant as the benefits were recognized on tax returns. Regulatory Assets – Noncurrent includes income taxes recoverable through future rates, which reflects the future revenues due us from ratepayers as these tax benefits reverse. See Note 3.

We account for federal energy credits generated prior to 2012 using the grant accounting model. The credit is treated as deferred revenue, which is recognized over the depreciable life of the underlying asset. The deferred tax benefit of the credit is treated as a reduction to income tax expense in the year the credit arises. Federal energy credits generated since 2012 are deferred as Regulatory Liabilities – Noncurrent and amortized as a reduction in Income Tax Expense over the tax life of the underlying asset. Income Tax Expense attributable to the reduction in tax basis is accounted for in the year the federal energy credit is generated and are deferred as regulatory assets effective July 1, 2013 due to the 2013 TEP Rate Order. All other 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**

We act as conduits or collection agents for sales taxes, utility taxes, franchise fees, and regulatory assessments. As we bill customers for these taxes and assessments, we record trade receivables. At the same time, we record liabilities payable to governmental agencies on the balance sheet for these taxes and assessments. These amounts are not reflected in the income statements.

**DERIVATIVE INSTRUMENTS**

We use various physical and financial derivative instruments, including forward contracts, financial swaps and call and put options, to meet forecasted load and reserve requirements, to reduce our exposure to energy commodity price volatility and to hedge our interest rate risk exposure. For all derivative instruments that do not meet the normal purchase or normal sale scope exception, we recognize derivative instruments as either assets or liabilities on the consolidated balance sheets and measure those instruments at fair value. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation.

**Cash Flow Hedges**

TEP hedges the cash flow risk associated with unfavorable changes in the variable interest rates related to the leveraged lease arrangements for the Springerville Common Lease and variable rate industrial development revenue or pollution control revenue bonds (IDBs). In addition, TEP hedges the cash flow risk associated with a long-term wholesale power supply agreement that does not qualify for regulatory recovery using a six-year power purchase swap agreement. UNS Electric uses a cash flow hedge to effectively convert the interest rate on the UNS Electric term loan from a variable rate to a fixed rate. TEP and UNS Electric account for cash flow hedges as follows:

- The effective portion of the change in the fair value is recorded in AOCI and the ineffective portion, if any, is recognized in earnings; and
- When TEP and UNS Electric determine a contract is no longer effective in offsetting the changes in cash flow of a hedged item, TEP and UNS Electric recognize the change 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.

**Energy Contracts - Regulatory Recovery**

TEP, UNS Electric and UNS Gas are authorized to recover the prudent costs of hedging activities entered into to mitigate energy price risk for retail customers. We record unrealized gains and losses on these energy derivatives as either a regulatory asset or regulatory liability to the extent they qualify for recovery through the PPFAC or PGA mechanism.

**Master Netting Agreements**

We have elected gross presentation for our derivative contracts under master netting agreements and collateral positions. We separate all derivatives into current and long-term portions on the balance sheet.

**Normal Purchases and Normal Sales**

We enter into forward energy purchase and sales contracts, including call options, with counterparties that have generating capacity to support our current load forecasts or counterparties that have load serving requirements. We have elected the normal purchase or normal sales exception for these contracts which are not required to be measured at fair value and are accounted for on an accrual basis.

**Commodity Trading**

We did not engage in trading of derivative financial instruments.

**PENSION AND OTHER RETIREE BENEFITS**

We sponsor noncontributory, defined benefit pension plans for substantially all employees and certain affiliate employees. Benefits are based on years of service and average compensation. We also provide limited health care and life insurance benefits for retirees.

We recognize the underfunded status of our defined benefit pension plans as a liability on our balance sheets. The underfunded status is measured as the difference between the fair value of the pension plans' assets and the projected benefit obligation for the pension plans. We recognize a regulatory asset to the extent these future costs are probable of recovery in the rates charged to retail customers and expect to recover these costs over the estimated service lives of employees.

Additionally, we maintain a Supplemental Executive Retirement Plan (SERP) for senior management. Changes in SERP benefit obligations are recognized as a component of AOCI.

Pension and other retiree benefit expenses are determined by actuarial valuations based on assumptions that we evaluate annually. See Note 10.

## NOTE 2. PENDING MERGER WITH FORTIS

On December 11, 2013, UNS Energy announced that it had entered into an agreement and plan of merger, subject to shareholder and required regulatory approvals, to be acquired by Fortis for $60.25 per share of Common Stock in cash. Following the merger, UNS Energy will continue as a wholly owned subsidiary of Fortis. The Board of Directors of each of UNS Energy and Fortis Parent have approved the merger.

## NOTE 3. REGULATORY MATTERS

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

**2013 TEP RATE ORDER**

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

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

- an increase in non-fuel retail Base Rates of approximately $76 million over adjusted test year revenues;
- an Original Cost Rate Base (OCRB) of approximately $1.5 billion and a Fair Value Rate Base (FVRB) of approximately $2.3 billion;

- a return on equity of 10.0%, a long-term cost of debt of 5.18%, and a short-term cost of debt of 1.42%, resulting in a weighted average cost of capital of 7.26%;
- a capital structure of approximately 43.5% equity, 56.0% long-term debt, and 0.5% short-term debt;
- a 0.68% return on the fair value increment of rate base (the fair value increment of rate base represents the difference between OCRB and FVRB of approximately $800 million);
- a revision in depreciation rates from an average rate of 3.32% to 3.0% for generation and distribution plant, primarily due to revised estimates of asset removal costs, which will have the effect of reducing depreciation expense by approximately $11 million annually; and
- an agreement by TEP to seek recovery of costs related to the discontinued Nogales transmission project from the FERC before seeking rate recovery from the ACC.

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

- a new Purchased Power and Fuel Adjustment Clause (PPFAC) credit of 0.1388 cents per kWh effective July 1, 2013. The credit reflects the following:
    - a reduction in the PPFAC bank balance, recorded in June 2013, as an increase to fuel expense, of $3 million related to prior sulfur credits; and
    - a transfer of $10 million, recorded in June 2013, from the PPFAC bank balance to a new regulatory asset to defer coal costs related to the San Juan mine fire. These costs will be eligible for recovery through the PPFAC upon final settlement with the San Juan operator related to insurance proceeds.
- a modification of the PPFAC mechanism to include recovery of generation-related lime costs offset by sulfur credits.
- a Lost Fixed Cost Recovery mechanism (LFCR) to recover certain non-fuel costs related to kWh sales lost due to energy efficiency programs and distributed generation. In the fourth quarter of 2013, TEP recorded revenues of $2 million related to unrecovered non-fuel costs incurred during 2013.
- an Environmental Compliance Adjustor (ECA) mechanism to recover certain capital carrying costs to comply with government-mandated environmental regulations between rate cases. The ECA rate is capped at 0.025 cents per kWh, which approximates 0.25% of TEP's total retail revenues, and will be charged to customers beginning in May 2014 for any qualifying costs incurred between August 2013 and December 2013.
- an energy efficiency provision which includes a 2013 calendar year budget of approximately $21 million to fund programs that support the ACC's Electric Energy Efficiency Standards, as well as a $2 million performance incentive.

**2013 UNS ELECTRIC RATE ORDER**

In December 2013, the ACC issued the 2013 UNS Electric Rate Order that resolved the rate case filed by UNS Electric in December 2012 which was based on a test year ended June 30, 2012. The 2013 UNS Electric Rate Order approved new rates effective January 1, 2014.

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

- an increase in non-fuel retail Base Rates of approximately $3 million;
- an OCRB of approximately $213 million and a FVRB of approximately $283 million;
- a return on equity of 9.50% and a long-term cost of debt of 5.97% resulting in a weighted average cost of capital of 7.83%;
- a 0.50% return on the fair value increment of rate base (the fair value increment of rate base represents the difference between OCRB and FVRB of approximately $70 million); and
- a capital structure of 52.6% equity and 47.4% long-term debt.

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

- a LFCR mechanism to recover certain non-fuel costs related to kWh sales lost due to energy efficiency programs and distributed generation; and
- a Transmission Cost Adjustor (TCA), which will allow more timely recovery of transmission costs associated with serving retail customers.

**2012 UNS GAS RATE ORDER**

In April 2012, the ACC approved a Base Rate increase of $2.7 million, or 1.8%, and an LFCR mechanism to enable UNS Gas to recover lost fixed cost revenues as a result of implementing the ACC's Gas Energy Efficiency Standards (Gas EE Standards).

The ACC approved an authorized rate of return of 8.3% on an OCRB of $183 million, and a 1.0% return on the fair value increment of rate base (the fair value increment of rate base represents the difference between OCRB and FVRB of approximately $70 million). The new rates became effective in May 2012.

**COST RECOVERY MECHANISMS**

TEP, UNS Electric, and UNS Gas have received regulatory decisions that allow for more timely recovery of certain costs through the recovery mechanisms described below.

**Purchased Power and Fuel Adjustment Clause**

TEP's PPFAC rate is adjusted annually each April 1st (unless otherwise approved by the ACC) and goes into effect for the subsequent 12-month period unless suspended by the ACC.

TEP's PPFAC rate includes: 1) a forward component, under which TEP recovers or refunds differences between a) forecasted fuel, transmission, and purchased power costs for the upcoming calendar year and b) those embedded in the fuel rate and the current PPFAC rates; and 2) a true-up component, which reconciles differences between prudently incurred actual fuel, transmission, and purchased power costs and those recovered through the combination of the fuel rate and the forward component for the preceding 12-month period.

Prior to the 2013 UNS Electric Rate Order, UNS Electric's PPFAC rate was adjusted annually each June 1st, effective for the subsequent 12-month period. As a result of the 2013 UNS Electric Rate Order, effective January 1, 2014, UNS Electric's PPFAC rate reflects a weighted 12-month rolling average of actual fuel and purchased power costs incurred by UNS Electric. The PPFAC rate adjusts monthly, but it is restricted from changing by more than 0.83 percent from the preceding month's rate. If the PPFAC deferral balance reflects an over-collection of $10 million or more on a billed-to-customer basis, UNS Electric must file for a PPFAC rate adjustment. At December 31, 2013, the PPFAC bank balance was over-collected by $14 million on a billed-to-customer basis.

The tables below summarize TEP's and UNS Electric's PPFAC rates:

| | TEP | | | |
|---|---|---|---|---|
| | 2013 | | 2012 | |
| | July - December | January - June | April - December | January - March |
| | Cents per kWh | | | |
| PPFAC Rate | 0.14 | 0.77 | 0.77 | 0.53 |
| Competition Transition Charge [(1)] | — | — | — | (0.53) |
| Net TEP PPFAC Rate | 0.14 | 0.77 | 0.77 | — |

(1) TEP's PPFAC became effective January 1, 2009. However, TEP was initially required to refund amounts to customers through the PPFAC mechanism that were over collected under the Competition Transition Charge (CTC) in place from 1999 through 2008. As a result, the authorized net PPFAC charge was set at zero until all over collected CTC revenue was fully refunded to customers (November 2011). TEP then continued deferring PPFAC eligible costs but was not authorized to bill customers until a new PPFAC rate was approved by the ACC in April 2012.

| | UNS Electric | | | | |
|---|---|---|---|---|---|
| | 2013 | | | 2012 | |
| | September - December | June - August | January - May | June - December | January - May |
| | Cents per kWh | | | | |
| PPFAC Rate | (0.40) | (0.92) | (1.44) | (1.44) | (0.88) |

**UNS Gas Purchased Gas Adjustor**

The PGA mechanism allows UNS Gas to adjust Retail Rates to recover fluctuations in natural gas costs. UNS Gas records deferrals for recovery or refund to the extent actual natural gas costs vary from the PGA rate. The PGA rate reflects a weighted, rolling average of the gas costs incurred by UNS Gas over the preceding 12 months. The PGA rate automatically adjusts monthly, but it is restricted from rising or falling more than 15 cents per therm in a twelve-month period. UNS Gas is required to request an additional surcredit if deferral balances reflect $10 million or more on a billed-to-customer basis.

In October 2013, the ACC approved an increase to the existing PGA credit from 4.5 cents per therm to 10 cents per therm in order to reduce the over-collected PGA bank balance. The new PGA credit will be effective for the period November 1, 2013 through April 30, 2014. At December 31, 2013 and December 31, 2012, the PGA bank balance was over-collected by $10 million on a billed-to-customer basis.

The PGA rate ranged from 0.4504 to 0.5280 cents per therm in 2013, and ranged from 0.5202 to 0.6501 cents per therm in 2012.

**Renewable Energy Standards**

TEP and UNS Electric are required to expand their use of renewable energy in order to meet the ACC’s RES. TEP and UNS Electric, through a customer surcharge, recover costs associated with meeting the RES. These costs include the purchases of RECs through Power Purchase Agreements (PPAs) and Performance Based Incentives (PBIs), as well as costs associated with utility-scale ownership of solar assets until the projects can be incorporated in Base Rates.

In October 2013, the ACC approved TEP's 2014 RES plan and authorized a total 2014 RES budget of $40 million with $34 million to be collected through the 2014 RES funding mechanism. TEP earned returns on solar investments of $2 million in each of 2013 and 2012 and $1 million in 2011.

In October 2013, the ACC approved UNS Electric's 2014 RES plan and authorized a total 2014 RES budget of $7 million with $6 million to be collected through the 2014 RES funding mechanism. UNS Electric earned returns on solar investments of less than $0.5 million in 2013 and 2012. No return was earned in 2011.

**Energy Efficiency Standards**

TEP, UNS Electric, and UNS Gas are required to implement cost-effective DSM programs to comply with the ACC’s EE Standards. The EE Standards provide for a DSM surcharge to recover, from retail customers, the costs to implement DSM programs.

In December 2013, the ACC approved UNS Electric’s 2013-2014 energy efficiency implementation plan that included a 2014 calendar year budget of approximately $5 million to fund programs that support the ACC’s Electric EE Standards as well as a performance incentive.

In June 2013, the ACC approved the UNS Gas 2011-2012 energy efficiency implementation plan with certain modifications. The approval included an annual energy efficiency budget of approximately $2 million and a waiver of the Gas EE Standards through 2013.

**Lost Fixed Cost Recovery Mechanism**

The LFCR is a mechanism to recover certain non-fuel costs that would go unrecovered due to lost sales as a result of implementing ACC approved EE Standards and distributed generation targets.

In April 2012, the ACC authorized a LFCR mechanism that enables UNS Gas to recover non-purchased energy related costs that would go unrecovered due to lost therm sales as a result of implementing the Gas EE Standards.

In June 2013, the ACC authorized a LFCR mechanism for TEP subject to a year-over-year cap of 1% of TEP's total retail revenues. TEP expects the LFCR rate which will recover 2013 costs, to be effective on July 1, 2014, upon review by the ACC of verified lost kWh sales.

In December 2013, as part of the 2013 UNS Electric Rate Order, the ACC authorized a LFCR for UNS Electric, to be effective on July 1, 2014.

**REGULATORY ASSETS AND LIABILITIES**

The following tables summarize regulatory assets and liabilities:

| | December 31, 2013 | | | |
|---|---|---|---|---|
| | TEP | UNS Electric | UNS Gas | UNS Energy |
| | Millions of Dollars | | | |
| **Regulatory Assets—Current** | | | | |
| Property Tax Deferrals [1] | $ 20 | $ — | $ — | $ 20 |
| Derivative Instruments (Note 15) | 1 | — | — | 1 |
| San Juan Mine Fire Cost Deferral [2] | 10 | — | — | 10 |
| PPFAC [2] | 4 | 10 | — | 14 |
| DSM and LFCR [2] | 3 | — | — | 3 |
| Other Current Regulatory Assets [3] | 5 | — | — | 5 |
| **Total Regulatory Assets—Current** | 43 | 10 | — | 53 |
| **Regulatory Assets—Noncurrent** | | | | |
| Pension and Other Retiree Benefits (Note 10) | 75 | 3 | 2 | 80 |
| Income Taxes Recoverable through Future Revenues [4] | 22 | 3 | — | 25 |
| PPFAC—Final Mine Reclamation and Retiree Health Care Costs [5] | 25 | — | — | 25 |
| Discontinued Nogales Transmission Project [6] | 5 | — | — | 5 |
| Other Regulatory Assets [3] | 14 | 2 | — | 16 |
| **Total Regulatory Assets—Noncurrent** | 141 | 8 | 2 | 151 |
| **Regulatory Liabilities—Current** | | | | |
| PGA [2] | — | — | (15) | (15) |
| RES [2] | (22) | (9) | — | (31) |
| Other Current Regulatory Liabilities | (2) | (6) | — | (8) |
| **Total Regulatory Liabilities—Current** | (24) | (15) | (15) | (54) |
| **Regulatory Liabilities—Noncurrent** | | | | |
| Net Cost of Removal for Interim Retirements [7] | (254) | (12) | (26) | (292) |
| Income Taxes Payable through Future Rates | (5) | — | (1) | (6) |
| Deferred Investment Tax Credit [8] | (4) | — | — | (4) |
| **Total Regulatory Liabilities—Noncurrent** | (263) | (12) | (27) | (302) |
| **Total Net Regulatory Assets (Liabilities)** | $ (103) | $ (9) | $ (40) | $ (152) |

| | December 31, 2012 | | | |
|---|---|---|---|---|
| | TEP | UNS Electric | UNS Gas | UNS Energy |
| | Millions of Dollars | | | |
| **Regulatory Assets—Current** | | | | |
| Property Tax Deferrals [1] | $ 18 | $ — | $ — | $ 18 |
| Derivative Instruments (Note 15) | 2 | 6 | 3 | 11 |
| PPFAC [2] | 7 | 8 | — | 15 |
| DSM [2] | 5 | — | — | 5 |
| Other Current Regulatory Assets [3] | 2 | — | 1 | 3 |
| **Total Regulatory Assets—Current** | 34 | 14 | 4 | 52 |
| **Regulatory Assets—Noncurrent** | | | | |
| Pension and Other Retiree Benefits (Note 10) | 130 | 5 | 4 | 139 |
| Income Taxes Recoverable through Future Revenues [4] | 8 | 2 | — | 10 |
| PPFAC—Final Mine Reclamation and Retiree Health Care Costs [5] | 22 | — | — | 22 |
| Discontinued Nogales Transmission Project [6] | 5 | — | — | 5 |
| Other Regulatory Assets [3] | 13 | 1 | 1 | 15 |
| **Total Regulatory Assets—Noncurrent** | 178 | 8 | 5 | 191 |
| **Regulatory Liabilities—Current** | | | | |
| PGA [2] | — | — | (17) | (17) |
| RES [2] | (19) | (4) | — | (23) |
| Other Current Regulatory Liabilities | (2) | (1) | (1) | (4) |
| **Total Regulatory Liabilities—Current** | (21) | (5) | (18) | (44) |
| **Regulatory Liabilities—Noncurrent** | | | | |
| Net Cost of Removal for Interim Retirements [7] | (231) | (11) | (25) | (267) |
| Income Taxes Payable through Future Rates | (5) | — | (1) | (6) |
| Deferred Investment Tax Credit [8] | (5) | — | — | (5) |
| Other Regulatory Liabilities | — | (1) | — | (1) |
| **Total Regulatory Liabilities—Noncurrent** | (241) | (12) | (26) | (279) |
| **Total Net Regulatory Assets (Liabilities)** | $ (50) | $ 5 | $ (35) | $ (80) |

Regulatory assets are either being collected in Retail Rates or are expected to be collected through Retail Rates in a future period. We describe regulatory assets below. With the exception of interest earned on under-recovered PPFAC costs, we do not earn a return on regulatory assets.

(1) Property Tax is recovered over approximately a six-month period as costs are paid, rather than as costs are accrued.

(2) See Cost Recovery Mechanisms discussion above.

(3) TEP's other regulatory assets include unamortized loss on reacquired debt (recovery through 2032), coal contract amendment (recovery through 2017), rate case costs (recovery over three years), environmental compliance costs, Springerville Unit 1 lease deferrals and other assets (recovery through 2014).

(4) Income Taxes Recoverable through Future Revenues are amortized over the life of the assets.

(5) Final Mine Reclamation and Retiree Health Care Costs stem from TEP's jointly-owned facilities at the San Juan Generating Station, the Four Corners Generating Station, and the Navajo Generating Station. TEP is required to recognize the present value of its liability associated with final mine reclamation and retiree health care obligations over the life of the coal supply agreements. TEP recorded a regulatory asset because TEP is permitted to fully recover these costs through the PPFAC when the costs are invoiced by the miners. TEP expects to recover these costs over the remaining life of the mines, which is estimated to be between 14 and 20 years.

(6) TEP and UNS Electric will request recovery from FERC for the prudent costs incurred to develop a high-voltage transmission line from Tucson to Nogales. TEP and UNS Electric are not going to proceed with the project. See Note 7.

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

(7) Net Cost of Removal for Interim Retirements represents amounts recovered through depreciation rates associated with asset retirement costs expected to be incurred in the future.

(8) The Deferred Investment Tax Credit relates to federal energy credits generated in 2012 and is amortized over the tax life of the underlying asset.

## IMPACTS OF REGULATORY ACCOUNTING

If we determine that we no longer meet the criteria for continued application of regulatory accounting, we would be required to write off our regulatory assets and liabilities related to those operations not meeting the regulatory accounting requirements. Discontinuation of regulatory accounting could have a material impact on our financial statements.

## NOTE 4. BUSINESS SEGMENTS

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

(1) TEP, a regulated electric utility and our largest subsidiary

(2) UNS Electric, a regulated electric utility

(3) UNS Gas, a regulated gas distribution utility

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

| | Reportable Segments | | | | | |
|---|---|---|---|---|---|---|
| | TEP | UNS Electric | UNS Gas | Other [2] | Reconciling Adjustments | UNS Energy |
| | Millions of Dollars | | | | | |
| **2013** | | | | | | |
| **Income Statement** | | | | | | |
| Operating Revenues-External | $ 1,180 | $ 174 | $ 131 | $ 2 | $ (2) | $ 1,485 |
| Operating Revenues-Intersegment [1] | 17 | 2 | 3 | 17 | (39) | — |
| Depreciation and Amortization | 149 | 19 | 9 | — | — | 177 |
| Interest Income | — | 1 | — | — | — | 1 |
| Interest Expense | 79 | 7 | 6 | 1 | — | 93 |
| Income Tax Expense | 48 | 7 | 7 | (4) | — | 58 |
| Net Income | 101 | 12 | 11 | 3 | — | 127 |
| **Cash Flow Statement** | | | | | | |
| Capital Expenditures | (253) | (56) | (17) | — | — | (326) |
| **Balance Sheet** | | | | | | |
| Total Assets | 3,563 | 404 | 311 | 1,194 | (1,192) | 4,280 |

| | Reportable Segments | | | | | |
|---|---|---|---|---|---|---|
| | TEP | UNS Electric | UNS Gas | Other [2] | Reconciling Adjustments | UNS Energy |
| | Millions of Dollars | | | | | |
| **2012** | | | | | | |
| **Income Statement** | | | | | | |
| Operating Revenues-External | $ 1,145 | $ 189 | $ 129 | $ — | $ (1) | $ 1,462 |
| Operating Revenues-Intersegment [1] | 17 | 1 | 4 | 18 | (40) | — |
| Depreciation and Amortization | 150 | 18 | 9 | — | — | 177 |
| Interest Income | — | — | — | 1 | — | 1 |
| Interest Expense | 88 | 8 | 6 | 3 | — | 105 |
| Income Tax Expense | 39 | 11 | 6 | — | — | 56 |
| Net Income | 65 | 17 | 9 | — | — | 91 |
| **Cash Flow Statement** | | | | | | |
| Capital Expenditures | (253) | (38) | (16) | — | — | (307) |
| **Balance Sheet** | | | | | | |
| Total Assets | 3,461 | 370 | 310 | 1,121 | (1,122) | 4,140 |
| **2011** | | | | | | |
| **Income Statement** | | | | | | |
| Operating Revenues-External | $ 1,141 | $ 188 | $ 149 | $ — | $ 1 | $ 1,479 |
| Operating Revenue-Intersegment [1] | 15 | 2 | 2 | 23 | (42) | — |
| Depreciation and Amortization | 140 | 17 | 8 | 1 | (1) | 165 |
| Interest Income | 4 | — | — | 1 | — | 5 |
| Interest Expense | 89 | 7 | 7 | 9 | — | 112 |
| Income Tax Expense | 52 | 11 | 7 | (1) | (2) | 67 |
| Net Income | 85 | 18 | 10 | — | (3) | 110 |
| **Cash Flow Statement** | | | | | | |
| Capital Expenditures | (352) | (96) | (13) | (34) | 121 | (374) |

[1] Operating Revenues – Intersegment includes common costs (system, facilities, etc.) allocated to affiliates on a cost-causative basis and recorded as revenue by TEP, sales of power between TEP and UNS Electric at third-party market prices, control area services provided by TEP to UNS Electric based on a FERC-approved tariff, sales of gas by UNS Gas at third-party market prices for use in UNS Electric's generating facilities, and supplemental workforce charges charges (primarily meter reading services) provided to the utilities by an unregulated affiliate.

[2] Other includes the UNS Energy and UES holding companies, Millennium, and UED.

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

### UTILITY PLANT

The following table shows Utility Plant in Service by major class:

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | December 31, | | December 31, | |
| | 2013 | 2012 | 2013 | 2012 |
| | Millions of Dollars | | | |
| **Plant in Service:** | | | | |
| Electric Generation Plant | $ 1,974 | $ 1,932 | $ 1,889 | $ 1,847 |
| Electric Transmission Plant | 912 | 842 | 825 | 796 |
| Electric Distribution Plant | 1,529 | 1,495 | 1,298 | 1,271 |
| Gas Distribution Plant | 252 | 240 | — | — |
| Gas Transmission Plant | 18 | 18 | — | — |
| General Plant | 356 | 347 | 312 | 309 |
| Intangible Plant - Software Costs [(1) (2)] | 142 | 124 | 141 | 123 |
| Intangible Plant - Other | 5 | 5 | — | — |
| Electric Plant Held for Future Use | 4 | 3 | 3 | 2 |
| **Total Plant in Service** | $ 5,192 | $ 5,006 | $ 4,468 | $ 4,348 |
| Utility Plant under Capital Leases[(3)] | $ 638 | $ 583 | $ 638 | $ 583 |

(1) Unamortized computer software costs were $40 million for UNS Energy and $39 million for TEP as of December 31, 2013, and $36 million for UNS Energy and $35 million for TEP as of December 31, 2012.

(2) The amortization of computer software costs in UNS Energy's and TEP's income statements was $14 million in 2013, $13 million in 2012, and $10 million in 2011.

(3) In 2013, TEP entered into agreements to purchase certain Springerville Unit 1 leased interests. See Note 6.

### TEP Utility Plant under Capital Leases

All TEP utility plant under capital leases is used in TEP's generation operations and amortized over the primary lease term. See Note 6. At December 31, 2013, the utility plant under capital leases includes: 1) Springerville Unit 1; 2) Springerville Common Facilities; and 3) Springerville Coal Handling Facilities. The following table shows the amount of lease expense incurred for TEP's generation-related capital leases:

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2013 | 2012 | 2011 |
| | Millions of Dollars | | |
| **Lease Expense:** | | | |
| Interest Expense – Included in: | | | |
| Capital Leases | 25 | $ 34 | $ 40 |
| Operating Expenses – Fuel | 2 | 3 | 4 |
| Other Expense | — | — | 1 |
| Amortization of Capital Lease Assets – Included in: | | | |
| Operating Expenses – Fuel | 5 | 4 | 3 |
| Operating Expenses – Amortization | 15 | 14 | 14 |
| **Total Lease Expense** | $ 47 | $ 55 | $ 62 |

Utility plant depreciation rates and approximate average remaining service lives based on the most recent depreciation studies available at December 31, 2013, were as follows:

| | TEP | |
|---|---|---|
| | December 31, 2013 | |
| | Annual Depreciation Rate [5] | Average Remaining Life in Years |
| **Major Class of Utility Plant in Service:** | | |
| Electric Generation Plant [1] | 3.31% | 22 |
| Electric Transmission Plant | 1.48% | 32 |
| Electric Distribution Plant [1] | 2.08% | 35 |
| General Plant [1] | 5.48% | 11 |
| Intangible Plant [2] | Various | Various |

| | UNS Electric | |
|---|---|---|
| | December 31, 2013 | |
| | Annual Depreciation Rate [5] | Average Remaining Life in Years |
| **Major Class of Utility Plant in Service:** | | |
| Electric Generation Plant | 2.56% | 36 |
| Electric Transmission Plant | 3.36% | 19 |
| Electric Distribution Plant | 3.97% | 15 |
| General Plant | 8.01% | 7 |
| Intangible Plant [3] | Various | Various |

| | UNS Gas | |
|---|---|---|
| | December 31, 2013 | |
| | Annual Depreciation Rate [5] | Average Remaining Life in Years |
| **Major Class of Utility Plant in Service:** | | |
| Gas Generation Plant | 2.37% | 41 |
| Gas Transmission Plant | 1.54% | 54 |
| General Plant | 4.38% | 7 |
| Intangible Plant [4] | Various | Various |

[1] In June 2013, the ACC issued the 2013 TEP Rate Order that approved a change in depreciation rates which reflects changes in the remaining average useful lives for our generation, distribution, and general plant assets. See Note 3.

[2] The majority of TEP's investment in intangible plant represents computer software, which is being amortized over its expected useful life based on either the average lives of 3 to 5 years for smaller application software or remaining lives ranging from 5 to 19 years for large enterprise software.

[3] UNS Electric's intangible plant primarily represents capitalized interconnection costs, which are amortized based on either an average life of 23 years or a remaining life of 35 years.

[4] UNS Gas' intangible plant consists of miscellaneous intangible assets, which are amortized over an average life of either 15 or 25 years.

[5] The depreciation rates represent a composite of the depreciation rates of assets within each major class of utility plant.

**JOINTLY-OWNED FACILITIES**

At December 31, 2013, TEP's interests in jointly-owned generating stations and transmission systems were as follows:

| | Ownership Percentage | Plant in Service | Construction Work in Progress | Accumulated Depreciation | Net Book Value |
|---|---|---|---|---|---|
| | | Millions of Dollars | | | |
| San Juan Units 1 and 2 | 50.0% | $ 448 | $ 6 | $ 230 | $ 224 |
| Navajo Units 1, 2, and 3 | 7.5% | 152 | 1 | 110 | 43 |
| Four Corners Units 4 and 5 | 7.0% | 101 | 2 | 75 | 28 |
| Luna Energy Facility | 33.3% | 53 | — | 2 | 51 |
| Transmission Facilities | Various | 330 | 43 | 190 | 183 |
| **Total** | | $ 1,084 | $ 52 | $ 607 | $ 529 |

TEP is responsible for its share of operating costs for the above facilities as well as providing financing. TEP accounts for its share of operating expenses and utility plant costs related to these facilities using proportionate consolidation.

**ASSET RETIREMENT OBLIGATIONS**

The accrual of AROs is primarily related to generation and photovoltaic assets and is included in Deferred Credits and Other Liabilities on the balance sheets. The following table reconciles the beginning and ending aggregate carrying amounts of ARO accruals on the balance sheets:

| | UNS Energy | |
|---|---|---|
| | December 31, | |
| | 2013 | 2012 |
| | Millions of Dollars | |
| **Beginning Balance** | $ 14 | $ 13 |
| Liabilities Incurred | 1 | — |
| Accretion Expense or Regulatory Deferral | 1 | 1 |
| Revisions to the Present Value of Estimated Cash Flows [1] | 7 | — |
| **Ending Balance** | $ 23 | $ 14 |

[1] Primarily related to changes in expected retirement dates of generating facilities.

The table above primarily reflects TEP's ARO obligations. UNS Electric's ARO obligations were less than $1 million at December 31, 2013 and 2012.

## 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 UNS Energy's and TEP's long-term debt in the statements of capitalization.

**UNS ENERGY CONVERTIBLE SENIOR NOTES**

In 2005, UNS Energy issued $150 million of 4.50% Convertible Senior Notes due in 2035. In 2012, UNS Energy converted approximately $147 million of the Convertible Senior Notes into approximately 4.3 million shares of Common Stock and redeemed $3 million for cash.

## TEP DEBT ISSUANCES AND REDEMPTIONS

### Unsecured Tax-Exempt Variable Rate Bonds

In November 2013, the Industrial Development Authority of Apache County, Arizona issued $100 million of tax-exempt, variable rate Industrial Development Revenue Bonds (IDRBs), due April 2032. The lender resets the interest rate monthly based on a percentage of an index rate equal to one-month LIBOR plus a bank margin rate; the rate at December 31, 2013 was 0.948% per annum. These bonds are multi-modal bonds, and the initial term is set at five years through November 2018, at which time the bonds will be subject to mandatory tender for purchase. Proceeds were deposited with a trustee to redeem $100 million variable rate bonds in December 2013.

### Secured Tax-Exempt Variable Rate Bonds and Interest Rate Swap

Certain of TEP's tax-exempt, variable rate bonds are secured by Letter of Credits (LOCs) issued under the TEP Credit Agreement and TEP Reimbursement Agreement, see below.

The following table shows interest rates on TEP's weekly variable rate bonds, which are reset weekly by its remarketing agents:

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2013 | 2012 | 2011 |
| **Interest Rates on Bonds:** | | | |
| Average Interest Rate | 0.10% | 0.17% | 0.18% |
| Range of Average Weekly Rates | 0.06% - 0.25% | 0.06% - 0.26% | 0.05% - 0.34% |

In August 2009, TEP entered into an interest rate swap that had the effect of converting $50 million of variable rate bonds to a fixed rate of 2.4% from September 2009 to September 2014.

### Unsecured Tax-Exempt Fixed Rate Bonds

In March 2013, TEP issued approximately $91 million aggregate principal amount of Pima County, Arizona, unsecured tax-exempt Industrial Development Bonds (IDBs). The bonds bear interest at a fixed rate of 4.0%, mature in September 2029, and may be redeemed at par on or after March 1, 2023. The proceeds from the sale of the bonds were deposited with a trustee to retire approximately $91 million of 6.375% unsecured tax-exempt bonds in April 2013.

In June 2012, TEP issued approximately $16 million of Pima County, Arizona, unsecured tax-exempt IDBs. The bonds bear interest at a fixed rate of 4.5%, mature in June 2030, and may be redeemed at par on or after June 1, 2022. The proceeds from the sale of the bonds were deposited with a trustee to retire approximately $16 million of unsecured, tax-exempt bonds with interest rates of 5.85% and 5.875%, and maturity dates ranging from 2026 to 2033.

In March 2012, TEP issued $177 million of Apache County, Arizona, unsecured, tax-exempt pollution control bonds. The bonds bear interest at a fixed rate of 4.5%, mature in March 2030, and may be redeemed at par on or after March 1, 2022. The proceeds from the sale of the bonds, together with $7 million of principal and $1 million for accrued interest provided by TEP, were deposited with a trustee to retire $184 million of unsecured tax-exempt bonds with interest rates of 5.85% and 5.875% and maturity dates ranging from 2026 to 2033.

### Unsecured Fixed Rate Notes

In September 2012, TEP issued $150 million of 3.85% unsecured notes due March 2023. TEP may call the debt prior to December 15, 2022, with a make-whole premium plus accrued interest. After December 15, 2022, TEP may call the debt at par plus accrued interest. The unsecured notes contain a limitation on the amount of secured debt that TEP may have outstanding. TEP used the net proceeds to repay approximately $72 million outstanding on the revolving credit facility, with the remaining proceeds used for general corporate purposes.

## TEP MORTGAGE INDENTURE

Prior to November 2013, the TEP Credit Agreement and the 2010 TEP Reimbursement Agreement were secured by $423 million in mortgage bonds issued under the 1992 Mortgage. As a result of TEP's credit rating upgrade, in October 2013, TEP canceled $423 million in mortgage bonds and discharged the 1992 Mortgage, which had created a lien on and security interest in substantially all of TEP's utility plant assets. TEP's obligations under the TEP Credit Agreement and the 2010 TEP Reimbursement Agreement are now unsecured.

**UNS ENERGY CREDIT AGREEMENT**

The UNS Energy Credit Agreement consists of a $125 million revolving credit facility and revolving LOC facility and expires in November 2016. UNS Energy's obligations under the agreement are secured by a pledge of the capital stock of Millennium, UES, and UED.

UNS Energy had $54 million of outstanding borrowings at December 31, 2013 and $45 million of outstanding borrowings at December 31, 2012, under its revolving credit facility. The weighted average interest rate on the revolver was 1.66% at December 31, 2013 and 1.96% at December 31, 2012. We report the revolver borrowings in Long-Term Debt on the balance sheet as UNS Energy has the ability and the intent to have outstanding borrowings for the next twelve months. As of February 14, 2014, outstanding borrowings under the UNS Energy Credit Agreement totaled $52 million.

Interest rates and fees under the UNS Energy Credit Agreement are based on a pricing grid tied to UNS Energy's credit ratings. The interest rate currently in effect on borrowings is LIBOR plus 1.25% for Eurodollar loans or Alternate Base Rate plus 0.25% for Alternate Base Rate loans.

**TEP CREDIT AGREEMENT**

The TEP Credit Agreement consists of a $200 million revolving credit, revolving LOC facility, and a $82 million LOC facility to support tax-exempt bonds, and expires in November 2016. In December 2013, TEP reduced its letter of credit facility from $186 million to $82 million, following the refinancing of $100 million of variable rate bonds and the cancellation of $104 million of LOCs supporting those bonds.

Interest rates and fees under the TEP Credit Agreement are based on a pricing grid tied to TEP's credit ratings. The interest rate currently in effect on borrowings is LIBOR plus 1.125% for Eurodollar loans or Alternate Base Rate plus 0.125% for Alternate Base Rate loans. The margin rate currently in effect on the $82 million LOC facility is 1.125%.

TEP had no borrowings and $1 million outstanding in LOCs issued under its revolving credit facility at December 31, 2013 and December 31, 2012. The revolving loan balance was included in Current Liabilities on UNS Energy's and TEP's balance sheets. The outstanding LOCs are off-balance sheet obligations of TEP. As of February 14, 2014, TEP had $90 million in borrowings and $1 million outstanding in LOCs under its revolving credit facility.

**2010 TEP REIMBURSEMENT AGREEMENT**

A $37 million LOC was issued pursuant to the 2010 TEP Reimbursement Agreement. The LOC supports $37 million aggregate principal amount of variable rate tax-exempt bonds that were issued on behalf of TEP in December 2010. In February 2014, TEP amended the agreement to extend the LOC expiration date from 2014 to 2019. Fees are payable on the aggregate outstanding amount of the LOC at a rate of 1.00% per annum.

**UNS ELECTRIC/UNS GAS CREDIT AGREEMENT**

The UNS Electric/UNS Gas Credit Agreement consists of a $100 million revolving credit and revolving LOC facility, and expires in November 2016. The maximum borrowings outstanding at any one time for UNS Gas or UNS Electric under the agreement may not exceed $70 million. UNS Electric and UNS Gas each are liable for only their own individual borrowings under the UNS Electric/UNS Gas Credit Agreement. UES guarantees the obligations of both UNS Electric and UNS Gas. The UNS Electric/UNS Gas Credit Agreement may be used to issue LOCs, as well as for revolver borrowings. UNS Electric and UNS Gas issue LOCs, which are off-balance sheet obligations, to support power and gas purchases and hedges.

Interest rates and fees under the UNS Electric/UNS Gas Credit Agreement are based on a pricing grid tied to their credit ratings. The interest rate currently in effect on borrowings is LIBOR plus 1.125% for Eurodollar loans or Alternate Base Rate plus 0.125% for Alternate Base Rate loans.

UNS Electric had $22 million in borrowings and less than $0.5 million in outstanding LOCs under the UNS Electric/UNS Gas Credit Agreement as of December 31, 2013. The revolving loan balance was included in Current Liabilities on UNS Energy's balance sheet. UNS Electric had no borrowings outstanding and less than $0.5 million LOCs under UNS Electric/UNS Gas Credit Agreement as of December 31, 2012. The oustanding LOCs balances are not shown on the balance sheet. As of February 14, 2014, UNS Electric had $25 million in borrowings and less than $0.5 million in outstanding LOCs under the UNS Electric/UNS Gas Credit Agreement.

## UNS ELECTRIC TERM LOAN CREDIT AGREEMENT AND INTEREST RATE SWAP

In August 2011, UNS Electric entered into a four-year $30 million variable rate term loan credit agreement. The interest rate currently in effect is three-month LIBOR plus 1.125%. At the same time, UNS Electric entered into a fixed-for-floating interest rate swap in which UNS Electric will pay a fixed rate of 0.97% and receive a three-month LIBOR rate on a $30 million notional amount over a four years period ending August 2015. The UNS Electric term loan credit agreement, included in Long-Term Debt on the balance sheet, is guaranteed by UES.

## COVENANT COMPLIANCE

Our credit agreements, the 2010 TEP Reimbursement Agreement, and certain of our long-term debt agreements contain restrictive covenants, including restrictions on additional indebtedness, liens to secure indebtedness, mergers, sales of assets, transactions with affiliates, and restricted payments. The UNS Energy Credit Agreement also requires UNS Energy to meet a minimum cash flow to interest coverage ratio, and each of our credit agreements stipulate a maximum leverage ratio. UNS Energy and its subsidiaries may pay dividends so long as we maintain compliance with our credit agreements.

At December 31, 2013, we were in compliance with the terms of our long-term debt, credit agreements, and the 2010 TEP Reimbursement Agreement. No amounts of net income were subject to dividend restrictions.

## TEP CAPITAL LEASE OBLIGATIONS

In January 2014, through scheduled lease payments, TEP reduced its capital lease obligations by $80 million.

### Springerville Unit 1 Capital Lease Purchase Commitments

The Springerville Unit 1 Leases have an initial term to January 2015, and include a fair market value purchase option at the end of the initial lease term. In 2011, TEP and the owner participants of Springerville Unit 1 completed a formal appraisal procedure to determine the fair market value purchase price of Springerville Unit 1 in accordance with the Springerville Unit 1 Leases. The purchase price was determined to be $478 per kW of capacity based on a capacity rating of 387 MW.

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

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

Upon close of these lease option purchases, TEP will own 49.5% of Springerville Unit 1, or 192 MW of capacity. Due to TEP's purchase commitments, TEP and UNS Energy recorded an increase of approximately $55 million to both Utility Plant Under Capital Leases and Capital Lease Obligations on their balance sheets.

### Springerville Coal Handling and Common Facilities Leases

The Springerville Coal Handling Facilities Leases have an initial term to April 2015 and provide for fixed-rate lease renewal options if certain conditions are satisfied as well as a fixed-price purchase provision of $120 million. The leases provide for one renewal period of six years beginning in April 2015, with additional renewal periods of five or more years through 2035.

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. Instead of extending the leases, TEP may exercise a fixed-price purchase provision. The fixed prices for the acquisition of the common facilities are $38 million in 2017 and $68 million in 2021.

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

**Lease Debt and Equity**

Investments in Springerville Lease Debt and Equity

In January 2013, TEP received the final maturity payment of $9 million on the investment in Springerville Unit 1 lease debt. TEP also held an undivided equity ownership interest in the Springerville Unit 1 Leases totaling $36 million at December 31, 2013 and December 31, 2012.

Interest Rate Swaps—Springerville Common Facilities Lease Debt

TEP's interest rate swaps hedge the floating interest rate risk associated with the Springerville Common Facilities lease debt. Interest on the lease debt is payable at six-month London Interbank Offered Rate (LIBOR) plus a spread. The applicable spread was 1.75% at December 31, 2013 and December 31, 2012.

The swaps have the effect of fixing the interest rates on the amortizing principal balances as follows:

| Lease Debt Outstanding at December 31, 2013 | Fixed Rate | LIBOR Spread |
|---|---|---|
| Swap 1 - Notional Amount $33 million - Effective Date June 2006 | 5.77% | 1.75% |
| Swap 2 - Notional Amount $16 million - Effective Date May 2009 | 3.18% | 1.75% |
| Swap 3 - Notional Amount $6 million - Effective Date May 2009 | 3.32% | 1.75% |

TEP recorded these interest rate swaps as a cash flow hedge for financial reporting purposes. See Note 15.

**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 Long-Term Debt Maturities [1] | TEP Capital Lease Obligations | TEP Total | UNS Electric | UNS Gas | UNS Energy Parent Company | Total |
|---|---|---|---|---|---|---|---|
| | | | | Millions of Dollars | | | |
| 2014 | $ — | $ 214 | $ 214 | $ — | $ — | $ — | $ 214 |
| 2015 | — | 69 | 69 | 80 | 50 | — | 199 |
| 2016 | 78 | 17 | 95 | — | — | 54 | 149 |
| 2017 | — | 18 | 18 | — | — | — | 18 |
| 2018 | 100 | 11 | 111 | — | — | — | 111 |
| Total 2014 – 2018 | 178 | 329 | 507 | 80 | 50 | 54 | 691 |
| Thereafter | 1,046 | 30 | 1,076 | 50 | 50 | — | 1,176 |
| Less: Imputed Interest | — | (42) | (42) | — | — | — | (42) |
| Total | $ 1,224 | $ 317 | $ 1,541 | $ 130 | $ 100 | $ 54 | $ 1,825 |

[1] $115 million of TEP's variable rate bonds are backed by LOCs issued pursuant to TEP's Credit Agreement, which expires in November 2016, and TEP's Reimbursement Agreement, which expires in December 2019. Although the variable rate bonds mature between 2022 and 2032, the above table reflects a redemption or repurchase of such bonds in 2016 and 2019 as though the LOCs terminate without replacement upon expiration of the TEP Credit Agreement. TEP's 2013 tax-exempt variable rate IDBs, which mature in 2032, are subject to mandatory tender for purchase after the current five-year term and are therefore reflected as maturing in 2018. The repayment of TEP Unsecured Notes is not reduced by the approximately $1 million discount.

## NOTE 7. COMMITMENTS, CONTINGENCIES, AND ENVIRONMENTAL MATTERS

### COMMITMENTS

At December 31, 2013, UNS Energy and TEP had the following firm, non-cancelable, minimum purchase obligations and operating leases. UNS Energy's commitments represent the obligations of TEP, UNS Electric, and UNS Gas:

| | UNS Energy Purchase Commitments | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2014 | 2015 | 2016 | 2017 | 2018 | Thereafter | Total |
| | Millions of Dollars | | | | | | |
| Fuel, Including Transportation | $ 103 | $ 83 | $ 80 | $ 75 | $ 49 | $ 345 | $ 735 |
| Purchased Power | 75 | 17 | — | — | — | — | 92 |
| Transmission | 7 | 13 | 12 | 12 | 11 | 27 | 82 |
| Renewable Power Purchase Agreements | 36 | 37 | 37 | 37 | 37 | 485 | 669 |
| RES Performance-Based Incentives | 9 | 9 | 9 | 9 | 9 | 85 | 130 |
| Operating Leases | 4 | 4 | 3 | 2 | 2 | 14 | 29 |
| **Total Purchase Commitments** | $ 234 | $ 163 | $ 141 | $ 135 | $ 108 | $ 956 | $ 1,737 |

At December 31, 2013, TEP had the following firm, non-cancelable, minimum purchase obligations and operating leases:

| | TEP Purchase Commitments | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2014 | 2015 | 2016 | 2017 | 2018 | Thereafter | Total |
| | Millions of Dollars | | | | | | |
| Fuel, Including Transportation | $ 77 | $ 63 | $ 64 | $ 62 | $ 36 | $ 285 | $ 587 |
| Purchased Power | 27 | 5 | — | — | — | — | 32 |
| Transmission | 3 | 6 | 6 | 6 | 6 | 21 | 48 |
| Renewable Power Purchase Agreements | 30 | 31 | 31 | 31 | 31 | 410 | 564 |
| RES Performance-Based Incentives | 8 | 8 | 8 | 8 | 8 | 83 | 123 |
| Operating Leases | 3 | 3 | 2 | 2 | 2 | 14 | 26 |
| **Total Purchase Commitments** | $ 148 | $ 116 | $ 111 | $ 109 | $ 83 | $ 813 | $ 1,380 |

#### Fuel

TEP has long-term contracts for the purchase and delivery of coal with various expiration dates through 2031. 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. TEP expects to spend more than the minimum purchase obligations to meet its fuel requirements. TEP's fuel costs are recoverable from customers through the PPFAC.

UNS Gas purchases gas from various supplies at market prices. However, UNS Gas' risk of loss due to increased costs is mitigated through the use of the PGA, which provides for the pass-through of actual commodity costs to customers. UNS Gas' forward gas purchase agreements expire through 2016. Certain of these contracts are at a fixed price per Million British Thermal Units (MMbtu) and others are indexed to natural gas prices. The commitment amounts included in the table are based on projected marked prices as of December 31, 2013. UNS Gas has firm transportation agreements with capacity sufficient to meet its load requirements. These contracts expire in various years between 2016 and 2023.

#### Purchased Power and Transmission

TEP and UNS Electric have 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 2014 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, 2013.

TEP has agreements with other utilities to provide transmission services. These contracts expire in various years between 2018 and 2028. 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 2016.

TEP's and UNS Electric's purchased power and transmission costs are recoverable from customers through their respective PPFAC mechanisms.

**Renewable Power Purchase Agreements and RES Performance-Based Incentives**

TEP and UNS Electric have entered into 20 year Renewable Power Purchase Agreements (PPAs) which require TEP and UNS Electric to purchase 100% of the output of certain renewable energy generation facilities that have achieved commercial operation. TEP has entered into additional long-term renewable PPAs to comply with RES requirements; however, TEP's obligation to purchase power under these agreements does not begin until the facilities are operational. A portion of the cost of renewable energy is recoverable through the PPFAC, with the balance of costs recoverable through the RES tariff. See Note 3.

TEP and UNS Electric have entered into REC purchase agreements to purchase the environmental attributes from retail customers with solar installations. Payments for the RECs are termed Performance-Based Incentives (PBIs) and are paid in contractually agreed-upon intervals (usually quarterly) based on metered renewable energy production. PBIs are recoverable through the RES tariff. See Note 3.

**Operating Leases**

Our operating lease expense is primarily for rail cars, office facilities, land easements, and rights of way with varying terms, provisions, and expiration dates. UNS Energy's operating lease expense totaled $3 million in each of 2013, 2012, and 2011, and TEP's operating lease expense totaled $2 million in each of 2013, 2012, and 2011.

**TEP CONTINGENCIES**

**Potential Purchase of Gas-Fired Generation Facility**

In 2013, TEP and UNS Electric entered into an agreement to purchase a gas-fired generation facility; see Note 8.

**Claim Related to San Juan Generating Station**

San Juan Coal Company (SJCC) operates an underground coal mine in an area where certain gas producers have oil and gas leases with the federal government, the State of New Mexico, and private parties. These gas producers allege that SJCC's underground coal mine interferes with their operations, reducing the amount of natural gas they can recover. SJCC compensated certain gas producers for any remaining production from wells deemed close enough to the mine to warrant plugging and abandoning them. These settlements, however, do not resolve all potential claims by gas producers in the area. TEP owns 50% of Units 1 and 2 at San Juan Generating Station (San Juan), which represents approximately 20% of the total generation capacity at San Juan, and is responsible for its share of any settlements. TEP cannot estimate the impact of any future claims by these gas producers on the cost of coal at San Juan.

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

**Claims Related to Four Corners Generating Station**

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

civil penalties, including a beneficial mitigation project. In April 2012, APS filed motions to dismiss with the court for all claims asserted by EarthJustice in the amended complaint. The joint participants have applied to have the matter stayed until March 17, 2014 in furtherance of settlement talks.

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

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

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

TEP pays ongoing reclamation costs related to coal mines that supply generating stations in which TEP has an ownership interest but does not operate. TEP is liable for a portion of final reclamation costs upon closure of the mines servicing Navajo, San Juan, and Four Corners. TEP's share of reclamation costs at all three mines is expected to be $44 million upon expiration of the coal supply agreements, which expire between 2017 and 2031. The reclamation liability (present value of future liability) recorded was $18 million at December 31, 2013 and $16 million at December 31, 2012.

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

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

**Discontinued Transmission Project**

TEP and UNS Electric had initiated a project to jointly construct a 60-mile transmission line from Tucson, Arizona to Nogales, Arizona in response to an order by the ACC to UNS Electric to improve the reliability of electric service in Nogales. TEP and UNS Electric will not proceed with the project based on the cost of the proposed 345-kV line, the difficulty in reaching agreement with the Forest Service on a path for the line, and concurrence by the ACC of recent transmission plans filed by TEP and UNS Electric supporting elimination of this project. As part of the 2013 TEP Rate Order, TEP agreed to seek recovery of the project costs from FERC before seeking rate recovery from the ACC. See Note 3. In 2012, TEP wrote off $5 million of the capitalized costs believed not probable of recovery and recorded a regulatory asset of $5 million for the balance deemed probable of recovery.

**Performance Guarantees**

The participants in each of the remote generating stations in which TEP participates, including TEP, have guaranteed certain performance obligations of the other participants. Specifically, in the event of payment default of a participant, the non-defaulting participants have agreed to bear a proportionate share of expenses otherwise payable by the defaulting participant. In exchange, the non-defaulting participants are entitled to receive their proportionate share of the generating capacity of the defaulting participants. TEP's joint participation agreements expire in 2016 through 2046.

**UNS ELECTRIC CONTINGENCIES**

**Potential Purchase of Gas-Fired Generation Facility**

In 2013, TEP and UNS Electric entered into an agreement to purchase a gas-fired generation facility. See Note 8.

## ENVIRONMENTAL MATTERS

### Environmental Regulation

The Environmental Protection Agency (EPA) limits the amount of sulfur dioxide ($SO_2$), nitrogen oxide (NOx), particulate matter, mercury and other emissions released into the atmosphere by power plants. TEP capitalized $5 million in 2013, $2 million in 2012, and $8 million in 2011 in construction costs to comply with environmental requirements. TEP expects to capitalize environmental compliance costs of $12 million in 2014 and $36 million in 2015. In addition, TEP recorded O&M expenses of $8 million in 2013, $15 million in 2012, and $12 million in 2011. TEP expects environmental O&M expenses to be $5 million in each of 2014 and 2015.

TEP may incur added costs to comply with future changes in federal and state environmental laws, regulations, and permit requirements at its power plants. Complying with these changes may reduce operating efficiency. TEP expects to recover the cost of environmental compliance from its ratepayers.

### Hazardous Air Pollutant Requirements

In February 2012, the EPA issued final rules for the control of mercury emissions and other hazardous air pollutants from power plants. Based on the EPA's final Mercury and Air Toxics (MATs) rule, additional emission control equipment will be required by 2015. The estimated costs include:

| Estimated Emissions Control Costs: | Navajo | Four Corners | Springerville |
|---|---|---|---|
| | | Millions of Dollars | |
| Capital Expenditures - Mercury Emissions Control | $ 1 | $ 1 | $ 5 |
| Annual O&M Expenses | 1 | 1 | 3 |

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

### Regional Haze Rules

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

In the western U.S., Regional Haze BART determinations have focused on controls for NOx, often resulting in a requirement to install SCRs. Complying with the EPA’s BART rules, and with other future environmental rules, may make it economically impractical to continue operating the Navajo, San Juan, and Four Corners power plants or for individual owners to continue to participate in these power plants. TEP cannot predict the ultimate outcome of these matters.

TEP's estimated potential costs involved in meeting these rules are:

| Estimated Potential Emissions Control Costs: | Navajo [1] | San Juan [2] | Four Corners [3] | Sundt [4] |
|---|---|---|---|---|
| | | Millions of Dollars | | |
| Capital - SCR | $ 42 | $ 180-200 | $ 35 | $ — |
| Capital - SNCR | — | 35 | — | 12 |
| Annual O&M - SCR | 1 | 6 | 2 | — |
| Annual O&M - SNCR | — | 1 | — | 5-6 |

(1) The EPA is considering a better-than-BART plan wherein: one unit at Navajo will be shut down by 2020; SCR installation (or the equivalent) will be installed on the remaining two units by 2030; and conventional coal-fired generation will cease by December 2044. TEP expects the EPA to reach a decision in 2014. In addition, the installation of SCR technology could increase particulates which may require that baghouses be installed. The additional capital cost of baghouses approximates $43 million with O&M on the baghouses expected to be less than $1 million per year.

[2] The Federal Implementation Plan (FIP) requires SCR; as part of a proposal for an alternative, PNM, the State of New Mexico, and the EPA signed a non-binding agreement in which PNM agreed to close Units 2 & 3 by December 31, 2017 and install SNCRs on Units 1 & 4 by January 2016 or later. The State of New Mexico has submitted this plan to the EPA for approval. TEP expects the EPA will reach a decision in 2014. TEP owns 50% of San Juan Unit 2. At December 31, 2013, the net book value of TEP's share in San Juan Unit 2 was $113 million. If Unit 2 is retired early, we expect to request ACC approval to recover, over a reasonable time period, all costs associated with the early closure of the unit.

[3] On December 30, 2013, APS, on behalf of the co-owners of Four Corners, notified the EPA that they have chosen the alternative BART compliance strategy; APS closed Units 1, 2, and 3 in December 2013 and has agreed to the installation of SCR on Units 4 & 5 by July 31, 2018. TEP owns 7% of Four Corners Units 4 and 5.

[4] In January 2014, the EPA issued a proposal that would require TEP to either (i) install SNCR by mid-2017 or (ii) eliminate the use of coal by the end of 2017 as a better-than-BART alternative. Under the proposal, TEP would be required to notify the EPA of its decision by July 31, 2015. The EPA is expected to issue a final BART determination by July 2014. At December 31, 2013, the net book value of the Sundt coal handling facilities was $27 million. If the coal handling facilities are retired early, we expect to request ACC approval to recover, over a reasonable time period, all the remaining costs of the coal handling facilities.

BART provisions of Regional Haze Rules requiring emission control upgrades do not apply to Springerville because the plant was built after the BART-applicable dates.

## NOTE 8. POTENTIAL PURCHASE OF GAS-FIRED GENERATION FACILITY

On December 23, 2013, TEP and UNS Electric entered into a purchase agreement with a subsidiary of Entegra to purchase Gila River Generating Station Unit 3 for $219 million, subject to certain closing adjustments. Gila River Unit 3, a gas-fired combined cycle unit with a nominal capacity rating of 550 MW, is located in Gila Bend, Arizona. TEP expects to purchase a 75% undivided interest in Gila River Unit 3 (413 MW) for approximately $164 million, and UNS Electric expects to purchase the remaining 25% undivided interest (137 MW) for approximately $55 million. TEP and UNS Electric expect the transaction to close in December 2014, subject to regulatory approvals and other closing conditions. In December 2013, UNS Electric filed an application for an accounting order with the ACC requesting authorization for UNS Electric to defer for future recovery specific non-fuel operating costs associated with Gila River Unit 3.

TEP expects to provide a letter of credit in March 2014 for $15 million to satisfy a condition of the purchase agreement. The seller of Gila River Unit 3 would be entitled to draw upon the letter of credit and apply such amount as liquidated damages if it has validly terminated the Purchase Agreement as a result of misrepresentations by TEP and UNS Electric or the failure of TEP and UNS Electric to close the transaction when the closing conditions have been satisfied. Upon the close of the transaction, the letter of credit would be canceled.

## NOTE 9. INCOME TAXES

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

| | UNS Energy | | | TEP | | |
|---|---|---|---|---|---|---|
| | Years Ended December 31, | | | | | |
| | 2013 | 2012 | 2011 | 2013 | 2012 | 2011 |
| | Millions of Dollars | | | | | |
| **Federal Income Tax Expense at Statutory Rate** | $ 65 | $ 51 | $ 62 | $ 52 | $ 37 | $ 48 |
| State Income Tax Expense, Net of Federal Deduction | 8 | 7 | 8 | 7 | 5 | 6 |
| Federal/State Tax Credits | (2) | (1) | (3) | (2) | (1) | (2) |
| Allowance for Equity Funds Used During Construction | (2) | (1) | (1) | (1) | (1) | (1) |
| Deferred Tax Asset Valuation Allowance | — | — | — | 2 | — | — |
| Investment Tax Credit Basis Adjustment - Creation of Regulatory Asset | (11) | — | — | (11) | — | — |
| Other | — | — | 1 | 1 | (1) | 1 |
| **Total Federal and State Income Tax Expense** | $ 58 | $ 56 | $ 67 | $ 48 | $ 39 | $ 52 |

**Investment Tax Credit Basis Adjustment - Creation of Regulatory Asset**

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

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

| | UNS Energy | | | TEP | | |
|---|---|---|---|---|---|---|
| | Years Ended December 31, | | | | | |
| | 2013 | 2012 | 2011 | 2013 | 2012 | 2011 |
| | Millions of Dollars | | | | | |
| Current Tax Expense (Benefit): | | | | | | |
| Federal | $ (11) | $ (2) | $ (7) | $ (8) | $ (4) | $ (5) |
| State | (2) | (2) | (2) | (2) | (2) | (2) |
| Total Current Tax Expense (Benefit) | (13) | (4) | (9) | (10) | (6) | (7) |
| Deferred Tax Expense (Benefit): | | | | | | |
| Federal | 61 | 51 | 64 | 47 | 38 | 50 |
| Federal Investment Tax Credits | (1) | — | (1) | (1) | — | (1) |
| State | 11 | 9 | 13 | 12 | 7 | 10 |
| Total Deferred Tax Expense (Benefit) | 71 | 60 | 76 | 58 | 45 | 59 |
| **Total Federal and State Income Tax Expense** | $ 58 | $ 56 | $ 67 | $ 48 | $ 39 | $ 52 |

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

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | December 31, | | December 31, | |
| | 2013 | 2012 | 2013 | 2012 |
| | Millions of Dollars | | | |
| **Gross Deferred Income Tax Assets:** | | | | |
| Capital Lease Obligations | $ 127 | $ 141 | $ 127 | $ 141 |
| Net Operating Loss Carryforwards | 94 | 72 | 104 | 85 |
| Customer Advances and Contributions in Aid of Construction | 33 | 34 | 19 | 19 |
| Alternative Minimum Tax Credit | 43 | 43 | 24 | 24 |
| Accrued Postretirement Benefits | 23 | 23 | 23 | 23 |
| Renewable Energy Credit Up-Front Incentive Payments | — | 26 | — | 20 |
| Emission Allowance Inventory | 10 | 10 | 10 | 10 |
| Unregulated Investment Losses | 7 | 9 | — | — |
| Other | 50 | 44 | 44 | 43 |
| **Total Gross Deferred Income Tax Assets** | 387 | 402 | 351 | 365 |
| **Deferred Tax Assets Valuation Allowance** | (7) | (7) | (2) | — |
| **Gross Deferred Income Tax Liabilities:** | | | | |
| Plant – Net | (708) | (648) | (615) | (571) |
| Capital Lease Assets – Net | (47) | (34) | (47) | (34) |
| Pensions | (21) | (23) | (22) | (24) |
| PPFAC | (5) | (6) | (2) | (3) |
| Other | (21) | (15) | (20) | (15) |
| **Total Gross Deferred Income Tax Liabilities** | (802) | (726) | (706) | (647) |
| **Net Deferred Income Tax Liabilities** | $ (422) | $ (331) | $ (357) | $ (282) |

The net deferred income tax liability on the balance sheet is as follows:

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | December 31, | | December 31, | |
| | 2013 | 2012 | 2013 | 2012 |
| | Millions of Dollars | | | |
| Deferred Income Taxes – Current Assets | $ 67 | $ 34 | $ 71 | $ 37 |
| Deferred Income Taxes – Noncurrent Liabilities | (489) | (365) | (428) | (319) |
| **Net Deferred Income Tax Liability** | $ (422) | $ (331) | $ (357) | $ (282) |

The unregulated investment loss deferred tax asset includes $7 million of capital loss at December 31, 2013 and December 31, 2012. The deferred tax asset can only be used if the company has capital gains to offset the losses. Management believes that it is more likely than not that the company will not be able to generate future capital gains. As a result, UNS Energy recorded a $7 million valuation allowance against the deferred tax asset as of December 31, 2013, and December 31, 2012. Management believes that based on its historical pattern of taxable income, UNS Energy will produce sufficient income in the future to realize all other deferred income tax assets.  TEP has recorded a $2 million valuation allowance against state tax credit carryforward deferred tax assets at December 31, 2013.  Management believes TEP will not produce sufficient taxable income to use all state tax credits before they expire.

**Income Tax Position**

As of December 31, 2013, UNS Energy and TEP had the following carryforward amounts:

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | Amount | Expiring Year | Amount | Expiring Year |
| | Millions of Dollars | | Millions of Dollars | |
| Capital Loss | $ 7 | 2015 | $ — | N/A |
| Federal Net Operating Loss | 266 | 2031-33 | 286 | 2031-33 |
| State Net Operating Loss | 30 | 2032-33 | 99 | 2016-33 |
| State Credits | 5 | 2016-18 | 6 | 2016-18 |
| Alternative Minimum Tax Credit | 43 | None | 24 | None |
| Investment Tax Credits | 6 | 2032-33 | 6 | 2032-33 |

If the pending Merger is approved there would be an annual limitation on the amount of carryforwards that can be utilized.

**Excess Tax Benefit Realized from Share-Based Compensation Plans**

UNS Energy records excess tax benefits as an increase to Common Stock when tax deductions for share-based compensation exceed the expense recorded in the financial statements and they result in a reduction to income taxes payable. As of December 31, 2013, UNS Energy had $4 million of excess tax benefits that were not recorded in Common Stock. The excess benefits will be recorded in Common Stock when the Federal net operating loss carryforwards of $266 million are used.

**Uncertain Tax Positions**

A reconciliation of the beginning and ending balances of unrecognized tax benefits follows:

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | December 31, | | December 31, | |
| | 2013 | 2012 | 2013 | 2012 |
| | Millions of Dollars | | | |
| **Unrecognized Tax Benefits, Beginning of Year** | $ 30 | $ 29 | $ 23 | $ 24 |
| Additions Based on Tax Positions Taken in the Current Year | 2 | 5 | 1 | 3 |
| Reductions of Positions from Prior Year Based on Tax Authority Ruling | (28) | (4) | (22) | (4) |
| **Unrecognized Tax Benefits, End of Year** | $ 4 | $ 30 | $ 2 | $ 23 |

Unrecognized tax benefits, if recognized, would not reduce income tax expense at December 31, 2013. Unrecognized tax benefits, if recognized, would reduce income tax expense by $1 million at December 31, 2012 for both UNS Energy and TEP.

UNS Energy and TEP recognized a $1 million reduction to interest expense in 2013 and no reduction in 2012. UNS Energy and TEP had no interest payable balance at December 31, 2013 and $1 million at December 31, 2012. We have no penalties accrued in the years presented.

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

UNS Energy and TEP have been audited by the IRS through tax year 2010 and the IRS has provided notice of intent to audit the 2011 tax returns. UNS Energy and TEP are not currently under audit by any state tax agencies. The balance in unrecognized tax benefits could change in the next 12 months as a result of ongoing IRS audits, but we are unable to determine the amount of change.

**Tangible Property Regulations**

In September 2013, the U.S. Treasury Department released final income tax regulations on the deduction and capitalization of expenditures related to tangible property. These final regulations apply to tax years beginning on or after January 1, 2014. Several of the provisions within the regulations will require a tax accounting method change to be filed with the IRS resulting in a cumulative effect adjustment. The adoption of these regulations by UNS Energy and TEP resulted in a $4 million increase to plant-related deferred tax liabilities and net operating loss deferred tax assets at December 31, 2013.

## NOTE 10. EMPLOYEE BENEFIT PLANS

### PENSION BENEFIT PLANS

We sponsor three noncontributory, defined benefit pension plans for substantially all employees and certain affiliate employees. Benefits are based on years of service and average compensation. We fund the pension plans by contributing at least the minimum amount required under Internal Revenue Service (IRS) regulations.

We also maintain a Supplemental Executive Retirement Plan (SERP) for executive management.

### OTHER RETIREE BENEFIT PLANS

TEP provides limited health care and life insurance benefits for retirees. Active TEP employees may become eligible for these benefits if they reach retirement age while working for TEP or an affiliate. UNS Electric and UNS Gas provide retiree medical benefits for current retirees. UNS Electric's and UNS Gas' active employees are not eligible for retiree medical benefits.

TEP funds its other retiree benefits for classified employees through a Voluntary Employee Beneficiary Association (VEBA). TEP contributed $3 million in each of 2013 and 2012 and $2 million in 2011 to the VEBA. Other retiree benefits for unclassified employees are self funded.

TEP’s other retiree benefit plan was amended in 2012 to increase the participant contributions for classified employees who retire after February 1, 2014. The effect on the benefit obligation was less than $1 million.

### REGULATORY RECOVERY

We record changes in our non-SERP pension plans and other retiree benefit plan, not yet reflected in net periodic benefit cost, as a regulatory asset, as such amounts are probable of future recovery in the rates charged to retail customers. Changes in the SERP obligation, not yet reflected in net periodic benefit cost, are recorded in Other Comprehensive Income since SERP expense is not currently recoverable in rates.

The pension and other retiree benefit related amounts (excluding tax balances) included on the UNS Energy balance sheet are:

| | Pension Benefits | | Other Retiree Benefits | |
|---|---|---|---|---|
| | Years Ended December 31, | | | |
| | 2013 | 2012 | 2013 | 2012 |
| | Millions of Dollars | | | |
| Regulatory Pension Asset Included in Other Regulatory Assets | $ 75 | $ 129 | $ 4 | $ 10 |
| Accrued Benefit Liability Included in Accrued Employee Expenses | (1) | (1) | (2) | (2) |
| Accrued Benefit Liability Included in Pension and Other Retiree Benefits | (28) | (90) | (63) | (69) |
| Accumulated Other Comprehensive Loss (related to SERP) | 2 | 4 | — | — |
| **Net Amount Recognized** | $ 48 | $ 42 | $ (61) | $ (61) |

The table above includes accrued pension benefit liabilities for UNS Electric and UNS Gas of approximately $5 million at December 31, 2013 and $9 million at December 31, 2012. The table also includes an other retiree benefit liability of $1 million for UNS Electric and UNS Gas for each period presented.

**OBLIGATIONS AND FUNDED STATUS**

We measured the actuarial present values of all pension benefit obligations and other retiree benefit plans at December 31, 2013 and December 31, 2012. The table below includes TEP's, UNS Electric's, and UNS Gas' plans. All plans have projected benefit obligations in excess of fair value of plan assets for each period presented. The status of our pension benefit and other retiree benefit plans are summarized below:

| | Pension Benefits | | Other Retiree Benefits | |
|---|---|---|---|---|
| | Years Ended December 31, | | | |
| | 2013 | 2012 | 2013 | 2012 |
| | Millions of Dollars | | | |
| **Change in Projected Benefit Obligation** | | | | |
| **Benefit Obligation at Beginning of Year** | $ 380 | $ 319 | $ 78 | $ 73 |
| Actuarial (Gain) Loss | (38) | 51 | (5) | 3 |
| Interest Cost | 15 | 15 | 3 | 3 |
| Service Cost | 13 | 10 | 3 | 3 |
| Benefits Paid | (18) | (15) | (4) | (4) |
| **Projected Benefit Obligation at End of Year** | 352 | 380 | 75 | 78 |
| **Change in Plan Assets** | | | | |
| **Fair Value of Plan Assets at Beginning of Year** | 289 | 245 | 7 | 5 |
| Actual Return on Plan Assets | 29 | 36 | 1 | 1 |
| Benefits Paid | (18) | (15) | (4) | (4) |
| Employer Contributions [1] | 23 | 23 | 6 | 5 |
| **Fair Value of Plan Assets at End of Year** | 323 | 289 | 10 | 7 |
| **Funded Status at End of Year** | $ (29) | $ (91) | $ (65) | $ (71) |

[1] TEP made $22 million in pension contributions and $6 million in other retiree benefits contributions in 2013 and $20 million in pension contributions and $5 million of other retiree benefits contributions in 2012. In 2014, UNS Energy expects to contribute $10 million to the pension plans, including $9 million in contributions by TEP.

The table above includes the following for UNS Electric and UNS Gas:

- Pension benefit obligations of $21 million at December 31, 2013 and $23 million at December 31, 2012;
- Plan assets of $16 million at December 31, 2013 and $14 million at December 31, 2012; and
- A retiree benefit obligation of $1 million at December 31, 2013 and December 31, 2012.

The following table provides the components of UNS Energy's regulatory assets and accumulated other comprehensive loss that have not been recognized as components of net periodic benefit cost as of the dates presented:

| | Pension Benefits | | Other Retiree Benefits | |
|---|---|---|---|---|
| | Years Ended December 31, | | | |
| | 2013 | 2012 | 2013 | 2012 |
| | Millions of Dollars | | | |
| Net Loss | $ 77 | $ 133 | $ 7 | $ 13 |
| Prior Service Cost (Benefit) | — | 1 | (3) | (3) |

The accumulated benefit obligation aggregated for all pension plans is $314 million at December 31, 2013 and $334 million at December 31, 2012.

**Information for Pension Plans with Accumulated Benefit Obligations in excess of Pension Plan Assets:**

| | December 31, 2013 | December 31, 2012 |
|---|---|---|
| | Millions of Dollars | |
| Accumulated Benefit Obligation at End of Year | 30 | 334 |
| Fair Value of Plan Assets at End of Year | 16 | 289 |

At December 31, 2012, all four UNS Energy defined benefit pension plans had accumulated benefit obligations in excess of plan assets. Due to 2013 contributions, returns on plan assets, and the favorable impact of the increase in the discount rate on the accumulated benefit obligations, only the SERP, which is unfunded, and the UES plan have accumulated benefit obligations in excess of plan assets at December 31, 2013.

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

| | Pension Benefits | | | Other Retiree Benefits | | |
|---|---|---|---|---|---|---|
| | Years Ended December 31, | | | | | |
| | 2013 | 2012 | 2011 | 2013 | 2012 | 2011 |
| | Millions of Dollars | | | | | |
| Service Cost | $ 13 | $ 10 | $ 10 | $ 4 | $ 3 | $ 3 |
| Interest Cost | 15 | 16 | 15 | 3 | 3 | 4 |
| Expected Return on Plan Assets | (20) | (17) | (16) | (1) | — | — |
| Prior Service Cost Amortization | — | — | — | (1) | — | (1) |
| Actuarial Loss Amortization | 9 | 7 | 6 | 1 | — | — |
| **Net Periodic Benefit Cost** | $ 17 | $ 16 | $ 15 | $ 6 | $ 6 | $ 6 |

Approximately 21% of the net periodic benefit cost was capitalized as a cost of construction and the remainder was included in income.

The changes in plan assets and benefit obligations recognized as regulatory assets or in AOCI are as follows:

| | Pension Benefits | | | | | |
|---|---|---|---|---|---|---|
| | 2013 | | 2012 | | 2011 | |
| | Regulatory Asset | AOCI | Regulatory Asset | AOCI | Regulatory Asset | AOCI |
| | Millions of Dollars | | | | | |
| Current Year Actuarial (Gain) Loss | $ (46) | $ (1) | $ 30 | $ 1 | $ 25 | $ (2) |
| Amortization of Actuarial Gain (Loss) | (8) | — | (7) | — | (5) | — |
| **Total Recognized (Gain) Loss** | $ (54) | $ (1) | $ 23 | $ 1 | $ 20 | $ (2) |

| | Other Retiree Benefits | | |
|---|---|---|---|
| | 2013 | 2012 | 2011 |
| | Regulatory Asset | Regulatory Asset | Regulatory Asset |
| | Millions of Dollars | | |
| Prior Service Cost (Credit) | $ — | $ — | $ (2) |
| Current Year Actuarial (Gain) Loss | (6) | 2 | — |
| Amortization of Actuarial (Gain) Loss | (1) | — | — |
| Amortization of Prior Service (Cost) Credit | 1 | — | 1 |
| **Total Recognized (Gain) Loss** | $ (6) | $ 2 | $ (1) |

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 $4 million estimated net loss and less than $1 million prior service cost from other regulatory assets and less than $1 million prior service cost from AOCI into net periodic benefit cost in 2014. The estimated prior service benefit for the other retiree benefit plan that will be amortized from other regulatory assets into net periodic benefit cost in 2014 is less than $1.0 million.

| | Pension Benefits | | Other Retiree Benefits | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| **Weighted-Average Assumptions Used to Determine Benefit Obligations as of December 31,** | | | | |
| Discount Rate | 5.0% - 5.2% | 4.1%-4.3% | 4.7% | 3.8% |
| Rate of Compensation Increase | 3.0% | 3.0% | N/A | N/A |

| | Pension Benefits | | | Other Retiree Benefits | | |
|---|---|---|---|---|---|---|
| | 2013 | 2012 | 2011 | 2013 | 2012 | 2011 |
| **Weighted-Average Assumptions Used to Determine Net Periodic Benefit Cost for Years Ended December 31,** | | | | | | |
| Discount Rate | 4.1%-4.3% | 4.9% - 5.0% | 5.5% - 5.6% | 3.8% | 4.7% | 5.2% |
| Rate of Compensation Increase | 3.0% | 3.0% | 3.0% - 5.0% | N/A | N/A | N/A |
| Expected Return on Plan Assets | 7.0% | 7.0% | 7.0% | 7.0% | 7.0% | 5.1% |

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.

We 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$^{th}$ percentile to the 75$^{th}$ 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. The assumed health care cost trend rates follow:

| | December 31, | |
|---|---|---|
| | 2013 | 2012 |
| Health Care Cost Trend Rate Assumed for Next Year | 6.7% | 6.9% |
| Ultimate Health Care Cost Trend Rate Assumed | 4.5% | 4.5% |
| Year that the Rate Reaches the Ultimate Trend Rate | 2027 | 2027 |

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, 2013, amounts:

| | One-Percentage-Point Increase | One-Percentage-Point Decrease |
|---|---|---|
| | Millions of Dollars | |
| Effect on Total Service and Interest Cost Components | $ 1 | $ (1) |
| Effect on Retiree Benefit Obligation | 6 | (5) |

**PENSION PLAN AND OTHER RETIREE BENEFIT ASSETS**

**Pension Assets**

We calculate the fair value of plan assets on December 31, the measurement date. Pension plan asset allocations, by asset category, on the measurement date were as follows:

| | TEP Plan Assets | | UNS Electric and UNS Gas Plan Assets | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| **Asset Category** | | | | |
| Equity Securities | 50% | 50% | 50% | 56% |
| Fixed Income Securities | 40 | 41% | 40 | 33 |
| Real Estate | 7 | 7% | 10 | 11 |
| Other | 3 | 2% | — | — |
| **Total** | 100% | 100% | 100% | 100% |

The following tables set forth the fair value measurements of pension plan assets by level within the fair value hierarchy:

| | Fair Value Measurements of Pension Assets December 31, 2013 | | | |
|---|---|---|---|---|
| | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
| | Millions of Dollars | | | |
| **Asset Category** | | | | |
| Cash Equivalents | $ 1 | $ — | $ — | $ 1 |
| Equity Securities: | | | | |
| United States Large Cap | — | 80 | — | 80 |
| United States Small Cap | — | 17 | — | 17 |
| Non-United States | — | 65 | — | 65 |
| Fixed Income | — | 130 | — | 130 |
| Real Estate | — | 9 | 14 | 23 |
| Private Equity | — | — | 7 | 7 |
| **Total** | $ 1 | $ 301 | $ 21 | $ 323 |

| | Fair Value Measurements of Pension Assets December 31, 2012 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| | Millions of Dollars | | | |
| **Asset Category** | | | | |
| Cash Equivalents | $ 1 | $ — | $ — | $ 1 |
| Equity Securities: | | | | |
| United States Large Cap | — | 71 | — | 71 |
| United States Small Cap | — | 15 | — | 15 |
| Non-United States | — | 59 | — | 59 |
| Fixed Income | — | 116 | — | 116 |
| Real Estate | — | 8 | 13 | 21 |
| Private Equity | — | — | 6 | 6 |
| **Total** | $ 1 | $ 269 | $ 19 | $ 289 |

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 commingled equity funds, United States bond funds, 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 using a real estate index value. The real estate index value was developed based on appraisals comprising 85% of real estate assets tracked by the index in 2013 and comprising 87% in 2012.

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

The tables above reflecting the fair value measurements of pension plan assets include Level 2 assets for the UNS Electric and UNS Gas pension plan of $16 million at December 31, 2013 and $14 million at December 31, 2012.

The following tables set forth a reconciliation of changes in the fair value of pension assets classified as Level 3 in the fair value hierarchy. There were no transfers in or out of Level 3.

| | Year Ended December 31, 2013 | | |
|---|---|---|---|
| | Private Equity | Real Estate | Total |
| | Millions of Dollars | | |
| **Beginning Balance at January 1, 2013** | $ 6 | $ 13 | $ 19 |
| Actual Return on Plan Assets: | | | |
| Assets Held at Reporting Date | 1 | 1 | 2 |
| Purchases, Sales, and Settlements | — | — | — |
| **Ending Balance at December 31, 2013** | $ 7 | $ 14 | $ 21 |

| | Year Ended December 31, 2012 | | |
|---|---|---|---|
| | Private Equity | Real Estate | Total |
| | Millions of Dollars | | |
| **Beginning Balance at January 1, 2012** | $ 4 | $ 11 | $ 15 |
| Actual Return on Plan Assets: | | | |
| Assets Held at Reporting Date | 1 | 2 | 3 |
| Purchases, Sales, and Settlements | 1 | — | 1 |
| **Ending Balance at December 31, 2012** | $ 6 | $ 13 | $ 19 |

UNS Electric and UNS Gas have no pension assets classified as Level 3 in the fair value hierarchy.

**Pension Plan Investments**

Investment Goals

Asset allocation is the principal method for achieving each pension plan's investment objectives while maintaining appropriate levels of risk. We 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 pension plan sponsor funding are reviewed in selecting policies to ensure that current asset pools are projected to be adequate to meet the expected liabilities of the pension 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.

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 pension plan's long-term investment objectives. In establishing risk tolerances, the following factors affecting risk tolerance and risk objectives will be considered: plan status, plan sponsor financial status and profitability, plan features, and workforce characteristics. We have determined that the pension plans can tolerate some interim fluctuations in market value and rates of return in order to achieve long-term objectives. TEP tracks each pension plan's portfolio relative to the benchmark through quarterly investment reviews. The reviews consist of a

performance and risk assessment of all investment categories and on the portfolio as a whole. Investment managers for the pension plan may use derivative financial instruments for risk management purposes or as part of their investment strategy. Currency hedges may also be used for defensive purposes.

Relationship between Plan Assets and Benefit Obligations

The overall health of each plan will be monitored by comparing the value of plan obligations (both Accumulated Benefit Obligation and Projected Benefit Obligation) against the fair 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 actuarial valuation.

Target Allocation Percentages

The current target allocation percentages for the major asset categories of the plan as of December 31, 2013 follow. Each plan allows a variance of +/- 2% from these targets before funds are automatically rebalanced.

| | TEP Plan | UNS Electric and UNS Gas Plan | VEBA Trust |
|---|---|---|---|
| Fixed Income | 41% | 42% | 38% |
| United States Large Cap | 24% | 24% | 39% |
| Non-United States Developed | 15% | 14% | 7% |
| Real Estate | 8% | 10% | —% |
| United States Small Cap | 5% | 5% | 5% |
| Non-United States Emerging | 5% | 5% | 9% |
| Private Equity | 2% | —% | —% |
| Cash/Treasury Bills | —% | —% | 2% |
| **Total** | 100% | 100% | 100% |

Pension Fund Descriptions

For each type of asset category selected by the Pension Committee, our investment consultant assembles a group of third-party fund managers and allocates a portion of the total investment to each fund manager. In the case of the private equity fund, our investment consultant directs investments to a private equity manager that invests in third-parties' funds.

Other Retiree Benefit Assets

As of December 31, 2013, the fair value of VEBA trust assets was $10 million, of which $4 million were fixed income investments and $6 million were equities. As of December 31, 2012, the fair value of VEBA trust assets was $7 million, of which $3 million were fixed income investments and $4 million were equities. The VEBA trust assets are primarily Level 2. There are no Level 3 assets in the VEBA trust.

**ESTIMATED FUTURE BENEFIT PAYMENTS**

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

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019-2023 |
|---|---|---|---|---|---|---|
| | Millions of Dollars | | | | | |
| Pension Benefits | $ 15 | $ 16 | $ 17 | $ 18 | $ 20 | $ 114 |
| Other Retiree Benefits | 5 | 5 | 5 | 5 | 5 | 29 |

One of TEP's noncontributory defined benefit pension plans was amended in 2012 to allow terminated participants to elect early retirement benefits equal to the actuarial equivalent of the participant's termination retirement benefit. The impact of the amendment on estimated future benefit payments was approximately $5 million in total, and the effect on the pension benefit obligation was less than $1 million.

UNS Electric and UNS Gas expect annual benefit payments, made by the defined benefit pension and retiree plans, to be approximately $7 million in 2014 through 2018, and $9 million in 2019 through 2023.

**DEFINED CONTRIBUTION PLAN**

We offer a defined contribution savings plan to all eligible employees. The Internal Revenue Code identifies the plan as a qualified 401(k) plan. Participants direct the investment of contributions to certain funds in their account which may include a UNS Energy stock fund. We match part of a participant's contributions to the plan. TEP made matching contributions to the plan of $5 million in each of 2013, 2012, and 2011. UNS Electric and UNS Gas made matching contributions of less than $1 million in each of 2013, 2012, and 2011.

## NOTE 11. SHARE-BASED COMPENSATION PLANS

Under the UNS Energy 2011 Omnibus Stock and Incentive Plan (2011 Plan), the Compensation Committee of the UNS Energy Board of Directors (Compensation Committee) may issue various types of share-based compensation, including stock options, restricted stock units, and performance shares. The total number of shares which may be awarded under the 2011 Plan cannot exceed 1.2 million shares.

**STOCK OPTIONS**

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. We recognize compensation expense 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, we recognize compensation expense immediately. No stock options were granted by the Compensation Committee in 2013, 2012, or 2011.

See summary of stock option activity in the table below:

| | 2013 | | 2012 | | 2011 | |
|---|---|---|---|---|---|---|
| Stock Options | Shares (000s) | Weighted Average Exercise Price | Shares (000s) | Weighted Average Exercise Price | Shares (000s) | Weighted Average Exercise Price |
| Outstanding, Beginning of Year | 409 | $ 29.09 | 581 | $ 29.11 | 921 | $ 27.96 |
| Exercised | (127) | 30.12 | (132) | 26.54 | (319) | 25.60 |
| Forfeited/Expired | — | — | (40) | 37.88 | (21) | 31.92 |
| Outstanding, End of Year | 282 | 28.63 | 409 | 29.09 | 581 | 29.11 |
| Exercisable, End of Year | 282 | $ 28.63 | 409 | $ 29.09 | 508 | $ 29.53 |
| Aggregate Intrinsic Value of Options Exercised ($000s) | | $ 2,897 | | $ 1,878 | | $ 3,690 |

See summary of stock options in the tables below:

| | December 31, 2013 |
|---|---|
| Aggregate Intrinsic Value for Options Outstanding ($000s) | $ 8,795 |
| Aggregate Intrinsic Value for Options Exercisable ($000s) | $ 8,795 |
| Weighted Average Remaining Contractual Term of Outstanding Options | 4.1 years |
| Weighted Average Remaining Contractual Term of Exercisable Options | 4.1 years |

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Range of Exercise Prices | Number of Shares (000s) | Weighted Average Remaining Contractual Term | Weighted Average Exercise Price | Number of Shares (000s) | Weighted Average Exercise Price |
| $26.11—$37.88 | 282 | 4.1 years | $ 28.63 | 282 | $ 28.63 |

## RESTRICTED STOCK UNITS AND PERFORMANCE SHARES

### Restricted Stock Units

In 2013, 2012, and 2011, the Compensation Committee granted restricted stock units to non-employee directors. We recognize compensation expense equal to the fair value on the grant date over the one-year vesting period. The grant date fair value was calculated by reducing the grant date share price by the present value of the dividends expected to be paid on the shares during the vesting period. Fully vested but undistributed non-employee director stock unit awards accrue dividend equivalent stock units based on the fair market value of common shares on the date the dividend is paid. We issue Common Stock for the vested stock units in the January following the year the person is no longer a director.

In 2013, the Compensation Committee granted restricted stock units to certain management employees. The restricted stock units vest on the third anniversary of grant and are distributed in shares of Common Stock upon vesting. We recognize compensation expense equal to the fair value on the grant date over the vesting period. The grant date fair value was the closing Common Stock market price on the date of grant. These restricted stock units accrue dividend equivalents during the vesting period, which are distributed in shares of Common Stock upon vesting.

See summary of restricted stock units awarded in the table below:

| | Non-Employee Directors | | Management Employees | |
|---|---|---|---|---|
| Award Year | Restricted Stock Units | Grant Date Fair Value | Restricted Stock Units | Grant Date Fair Value |
| 2013 | 8,870 | $ 48.99 | 21,560 | $ 46.23 |
| 2012 | 15,303 | 35.94 | — | — |
| 2011 | 14,655 | 37.53 | — | — |

### Performance Shares

In 2013, 2012, and 2011, the Compensation Committee granted performance share awards to certain management employees. Half of the performance share awards will be paid out in Common Stock based on UNS Energy's compound annualized Total Shareholder Return (TSR) relative to the companies included in the Edison Electric Institute Utility Index for the three-year performance period. The grant date fair values of these awards were derived based on a Monte Carlo simulation. We recognize compensation expense equal to the fair value on the grant date over the vesting period if the requisite service period is fulfilled, whether or not the threshold is achieved. The remaining half will be paid out in Common Stock based on cumulative net income (CNI) for the three-year performance period. The grant date fair values of these awards were the closing Common Stock market prices on the dates of grant. We recognize compensation expense equal to the fair value on the grant date over the requisite service period only for the awards that ultimately vest.

The performance shares vest based on the achievement of these goals by the end of the three-year performance period; any unearned awards are forfeited. Performance shares accrue dividend equivalents during the performance period, which are paid upon vesting.

See summary of performance shares awarded in the table below:

| | | Grant Date Fair Value | |
|---|---|---|---|
| Award Year | Performance Shares | TSR-Based Award | CNI-Based Award |
| 2013 | 43,120 | $ 45.54 | $ 46.23 |
| 2012 | 80,140 | 32.71 | 36.40 |
| 2011 | 80,440 | 33.73 | 36.58 |

At December 31, 2013, upon completion of the three-year performance period, 68,158 shares were earned and vested based on goal attainment at 150% of target for the awards based on TSR and 57.8% of target for the awards based on CNI; 28,682 shares were unearned and forfeited. The vested performance shares also earned 8,521 in dividend equivalent shares.

See summary of restricted stock units and performance shares current year activity in the table below:

| | Restricted Stock Units | | Performance Shares | |
|---|---|---|---|---|
| | Shares (000s) | Weighted Average Grant Date Fair Value | Shares (000s) | Weighted Average Grant Date Fair Value |
| Non-vested, Beginning of Year | 15 | $ 35.94 | 145 | $ 34.83 |
| Granted | 31 | 47.04 | 52 | 44.94 |
| Vested | (16) | 36.27 | (52) | 35.35 |
| Forfeited | (2) | 46.23 | (32) | 37.57 |
| Non-vested, End of Year | 28 | 47.12 | 113 | 38.45 |

The total fair value of restricted stock units and performance shares vested were as follows:

| | Restricted Stock Units | | | Performance Shares | | |
|---|---|---|---|---|---|---|
| | 2013 | 2012 | 2011 | 2013 | 2012 | 2011 |
| | Thousands of Dollars | | | | | |
| Total Fair Value of Shares Vested | $ 574 | $ 550 | $ 495 | $ 2,387 | $ 2,377 | $ 1,069 |

Common Stock shares totaling 57,253 in 2013, 31,058 in 2012, and 56,705 in 2011 were issued with no additional increase in equity as the expense was previously recognized over the vesting period.

**SHARE-BASED COMPENSATION EXPENSE**

In 2013, UNS Energy and TEP recorded share-based compensation expense of $3 million. In 2012 and 2011, UNS Energy recorded share-based compensation expense of $3 million, $2 million of which related to TEP. No share-based compensation was capitalized as part of the cost of an asset. UNS Energy did not realize a tax deduction from the exercise of share-based payment arrangements in 2013 or 2011. In 2012, the actual tax deduction realized from the exercise of share-based payment arrangements totaled less than $0.5 million.

At December 31, 2013, the total unrecognized compensation cost related to non-vested share-based compensation was $3 million, which will be recorded as compensation expense over the remaining vesting periods through February 2016. At December 31, 2013, less than 0.5 million shares were awarded but not yet issued, including target performance shares, under the share-based compensation plans.

**NOTE 12. UNS ENERGY EARNINGS PER SHARE**

We compute basic Earnings Per Share (EPS) by dividing Net Income by the weighted average number of common shares outstanding during the period. Diluted EPS reflects the potential dilution that could result if outstanding stock options, share-based compensation awards, or UNS Energy's Convertible Senior Notes were exercised or converted into Common Stock. We excluded anti-dilutive stock options and contingently issuable shares from the calculation of diluted EPS. The numerator in calculating diluted EPS is Net Income adjusted for the interest on Convertible Senior Notes (net of tax) that would not be paid if the notes were converted to Common Stock.

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

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2013 | 2012 | 2011 |
| | | Thousands of Dollars | |
| **Numerator:** | | | |
| Net Income | $ 127,478 | $ 90,919 | $ 109,975 |
| Income from Assumed Conversion of Convertible Senior Notes [(1)] | — | 1,100 | 4,390 |
| **Adjusted Net Income Available for Diluted Common Stock Outstanding** | $ 127,478 | $ 92,019 | $ 114,365 |
| | | Thousands of Shares | |
| **Denominator:** | | | |
| Weighted Average Shares of Common Stock Outstanding: | | | |
| Common Shares Issued | 41,446 | 40,212 | 36,780 |
| Fully Vested Deferred Stock Units | 172 | 150 | 129 |
| Participating Securities | — | — | 53 |
| **Total Weighted Average Common Stock Outstanding and Participating Securities—Basic** | 41,618 | 40,362 | 36,962 |
| Effect of Dilutive Securities: | | | |
| Convertible Senior Notes [(1)] | — | 1,062 | 4,281 |
| Options and Stock Issuable Under Share-Based Compensation Plans | 357 | 331 | 366 |
| **Total Weighted Average Common Stock Outstanding —Diluted** | 41,975 | 41,755 | 41,609 |

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

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

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2013 | 2012 | 2011 |
| | | Thousands of Shares | |
| Stock Options | — | 50 | 153 |
| Restricted Stock Units | 6 | — | — |
| **Total Anti-Dilutive Shares Excluded from the Diluted EPS Computation** | 6 | 50 | 153 |

## NOTE 13. STOCKHOLDERS' EQUITY

### DIVIDEND LIMITATIONS

### UNS Energy

UNS Energy's 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. UNS Energy and each of its subsidiaries were in compliance with debt covenants at December 31, 2013; therefore, TEP and the other subsidiaries were not restricted from paying dividends.

The merger agreement with Fortis allows UNS Energy's Board of Directors to authorize quarterly dividends of up to $0.48 per share until the merger is completed, including a pro rata dividend determined by the number of days from the last declared record date to the date the merger is completed.

In February 2014, UNS Energy declared a first quarter dividend to shareholders of $0.48 per share of UNS Energy Common Stock. The dividend, totaling approximately $20 million, will be paid on March 25, 2014, to common shareholders of record as of March 13, 2014.

In the first half of 2012, $147 million of the Convertible Senior Notes outstanding were converted into approximately 4.3 million shares of UNS Energy Common Stock increasing common stock equity by $147 million.

**TEP**

TEP paid dividends to UNS Energy of $40 million in 2013 and $30 million in 2012. TEP paid no dividends to UNS Energy in 2011.

UNS Energy made no capital contributions to TEP in 2013 or 2012, and made capital contributions to TEP of $30 million in 2011.

## NOTE 14. SUPPLEMENTAL CASH FLOW INFORMATION

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

| | UNS Energy | | |
|---|---|---|---|
| | Years Ended December 31, | | |
| | 2013 | 2012 | 2011 |
| | | Thousands of Dollars | |
| **Net Income** | $ 127,478 | $ 90,919 | $ 109,975 |
| **Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities** | | | |
| Depreciation Expense | 149,615 | 141,303 | 133,832 |
| Amortization Expense | 27,557 | 35,784 | 30,983 |
| Depreciation and Amortization Recorded to Fuel and O&M Expense | 7,288 | 6,622 | 6,140 |
| Amortization of Deferred Debt-Related Costs included in Interest Expense | 3,050 | 3,000 | 3,985 |
| Provision for Retail Customer Bad Debts | 2,263 | 2,767 | 2,072 |
| Use of Renewable Energy Credits for Compliance | 17,706 | 5,935 | 5,695 |
| Deferred Income Taxes | 83,501 | 60,264 | 75,515 |
| Investment Tax Credit Basis Adjustment - Creation of Regulatory Asset | (11,039) | — | — |
| Pension and Retiree Expense | 22,783 | 21,856 | 21,202 |
| Pension and Retiree Funding | (29,161) | (29,058) | (28,775) |
| Share-Based Compensation Expense | 3,399 | 2,573 | 2,599 |
| Allowance for Equity Funds Used During Construction | (6,190) | (3,464) | (4,496) |
| Increase (Decrease) to Reflect PPFAC/PGA Recovery | (16,313) | 32,246 | (4,932) |
| PPFAC Reduction - 2013 TEP Rate Order | 3,000 | — | — |
| Competition Transition Charge Revenue Refunded | — | — | (35,958) |
| Partial Write-off of Tucson to Nogales Transmission Line | — | 4,668 | — |
| Liquidated Damages for Springerville Unit 3 Outage | — | 2,050 | — |
| Gain on Settlement of El Paso Electric Dispute | — | — | (7,391) |
| Changes in Assets and Liabilities which Provided (Used) | | | |
| Cash Exclusive of Changes Shown Separately | | | |
| Accounts Receivable | (6,338) | 3,369 | 2,743 |
| Materials and Fuel Inventory | 16,197 | (39,429) | (20,864) |
| Accounts Payable | 3,223 | 595 | 8,792 |
| Income Taxes | (15,868) | (11,557) | (2,739) |
| Interest Accrued | 4,875 | 6,922 | 14,344 |
| Taxes Other Than Income Taxes | 1,941 | (58) | 2,857 |
| Current Regulatory Liabilities | 11,124 | (684) | 2,644 |
| Other | 20,421 | 11,486 | 19,097 |
| **Net Cash Flows – Operating Activities** | $ 420,512 | $ 348,109 | $ 337,320 |

| | TEP | | |
|---|---|---|---|
| | Years Ended December 31, | | |
| | 2013 | 2012 | 2011 |
| | | Thousands of Dollars | |
| **Net Income** | $ 101,342 | $ 65,470 | $ 85,334 |
| **Adjustments to Reconcile Net Income** | | | |
| **To Net Cash Flows from Operating Activities** | | | |
| Depreciation Expense | 118,076 | 110,931 | 104,894 |
| Amortization Expense | 31,294 | 39,493 | 34,650 |
| Depreciation and Amortization Recorded to Fuel and O&M Expense | 6,219 | 5,384 | 4,509 |
| Amortization of Deferred Debt-Related Costs Included in Interest Expense | 2,452 | 2,227 | 2,378 |
| Provision for Retail Customer Bad Debts | 1,678 | 1,871 | 1,447 |
| Use of RECs for Compliance | 15,990 | 5,071 | 5,190 |
| Deferred Income Taxes | 69,950 | 45,232 | 59,309 |
| Investment Tax Credit Basis Adjustment - Creation of Regulatory Asset | (10,751) | — | — |
| Pension and Retiree Expense | 19,878 | 19,289 | 18,816 |
| Pension and Retiree Funding | (27,636) | (25,899) | (25,878) |
| Share-Based Compensation Expense | 2,709 | 2,029 | 2,027 |
| Allowance for Equity Funds Used During Construction | (4,526) | (2,840) | (3,842) |
| Increase (Decrease) to Reflect PPFAC Recovery | (12,458) | 31,113 | (6,165) |
| PPFAC Reduction - 2013 TEP Rate Order | 3,000 | — | — |
| Competition Transition Charge Revenue Refunded | — | — | (35,958) |
| Partial Write-off of Tucson to Nogales Transmission Line | — | 4,484 | — |
| Liquidated Damages for Springerville Unit 3 Outage | — | 2,050 | — |
| Gain on Settlement of El Paso Electric Dispute | — | — | (7,391) |
| Changes in Assets and Liabilities which Provided (Used) | | | |
| Cash Exclusive of Changes Shown Separately | | | |
| Accounts Receivable | (6,041) | (871) | 4,809 |
| Materials and Fuel Inventory | 16,145 | (38,384) | (19,789) |
| Accounts Payable | 334 | 1,115 | 14,561 |
| Income Taxes | (10,790) | (11,421) | (5,582) |
| Interest Accrued | 4,859 | 8,055 | 14,268 |
| Taxes Other Than Income Taxes | 1,425 | 905 | 2,282 |
| Current Regulatory Liabilities | 3,331 | (3,040) | 303 |
| Other | 19,711 | 5,655 | 18,122 |
| **Net Cash Flows – Operating Activities** | $ 346,191 | $ 267,919 | $ 268,294 |

**NON-CASH TRANSACTIONS**

In 2013, the following non-cash transactions occurred:

- TEP recorded an increase of $55 million to both Utility Plant Under Capital Leases and Capital Lease Obligations due to TEP's commitment to purchase leased interests in December 2014 and January 2015. See Note 6.
- In November 2013, TEP issued $100 million of tax-exempt bonds and the proceeds were deposited with the trustee to redeem debt in December 2013. TEP had no cash receipts or payments as a result of this transaction. See Note 6.

- In March 2013, TEP issued $91 million of tax-exempt bonds and used the proceeds to redeem debt using a trustee. Since the cash flowed through a trust account, the issuance and redemption of debt resulted in a non-cash transaction. See Note 6.

In 2012, the following non-cash transactions occurred:

- UNS Energy converted $147 million of the previously outstanding $150 million Convertible Senior Notes into Common Shares. See Note 6; and
- TEP redeemed $193 million of tax-exempt bonds and reissued debt using a trustee. Since the cash flowed through trust accounts, the redemption and reissuance of debt resulted in a non-cash transaction at TEP. See Note 6.

Other non-cash investing and financing activities that affected recognized assets and liabilities but did not result in cash receipts or payments were as follows:

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2013 | 2012 | 2011 |
| | | Thousands of Dollars | |
| (Decrease)/Increase to Utility Plant Accruals[1] | $ 4,995 | $ 4,813 | $ (2,741) |
| Net Cost of Removal of Interim Retirements[2] | 25,182 | 35,983 | 31,626 |
| Capital Lease Obligations[3] | 9,039 | 11,967 | 15,162 |
| Asset Retirement Obligations[4] | 8,064 | 789 | 7,638 |

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

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

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

(4) The non-cash additions to asset retirement obligations and related capitalized assets represent revision of estimated asset retirement cost due to changes in timing and amount of expected future asset retirement obligations.

## NOTE 15. FAIR VALUE MEASUREMENTS AND DERIVATIVE INSTRUMENTS

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

**FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A RECURRING BASIS**

The following tables present, by level within the fair value hierarchy, UNS Energy's and TEP's assets and liabilities accounted for at fair value on a recurring basis. These assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| | UNS Energy | | | | | |
|---|---|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 | Counterparty Netting of Energy Contracts Not Offset on the Balance Sheets[5] | Net Amount |
| | December 31, 2013 | | | | | |
| | Millions of Dollars | | | | | |
| **Assets** | | | | | | |
| Cash Equivalents[1] | $ 14 | $ 14 | $ — | $ — | $ — | $ 14 |
| Restricted Cash[1] | 2 | 2 | — | — | — | 2 |
| Rabbi Trust Investments[2] | 22 | — | 22 | — | — | 22 |
| Energy Contracts - Regulatory Recovery[3] | 7 | — | 3 | 4 | (5) | 2 |
| **Total Assets** | 45 | 16 | 25 | 4 | (5) | 40 |
| **Liabilities** | | | | | | |
| Energy Contracts - Regulatory Recovery[3] | (7) | — | (2) | (5) | 5 | (2) |
| Energy Contracts - Cash Flow Hedge[3] | (1) | — | — | (1) | — | (1) |
| Interest Rate Swaps[4] | (7) | — | (7) | — | — | (7) |
| **Total Liabilities** | (15) | — | (9) | (6) | 5 | (10) |
| **Net Total Assets (Liabilities)** | $ 30 | $ 16 | $ 16 | $ (2) | $ — | $ 30 |

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

| | TEP | | | | | |
|---|---|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 | Counterparty Netting of Energy Contracts Not Offset on the Balance Sheets[5] | Net Amount |
| | December 31, 2013 | | | | | |
| | Millions of Dollars | | | | | |
| **Assets** | | | | | | |
| Cash Equivalents[1] | $ — | $ — | $ — | $ — | $ — | $ — |
| Restricted Cash[1] | 2 | 2 | — | — | — | 2 |
| Rabbi Trust Investments[2] | 22 | — | 22 | — | — | 22 |
| Energy Contracts - Regulatory Recovery[3] | 2 | — | 1 | 1 | (1) | 1 |
| **Total Assets** | 26 | 2 | 23 | 1 | (1) | 25 |
| **Liabilities** | | | | | | |
| Energy Contracts - Regulatory Recovery[3] | (2) | — | — | (2) | 1 | (1) |
| Energy Contracts - Cash Flow Hedge[3] | (1) | — | — | (1) | — | (1) |
| Interest Rate Swaps[4] | (7) | — | (7) | — | — | (7) |
| **Total Liabilities** | (10) | — | (7) | (3) | 1 | (9) |
| **Net Total Assets (Liabilities)** | $ 16 | $ 2 | $ 16 | $ (2) | $ — | $ 16 |

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

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

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

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

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

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

**DERIVATIVE INSTRUMENTS**

We primarily apply the market approach for recurring fair value measurements. When we have observable inputs for substantially the full term of the asset or liability or use quoted prices in an inactive market, we categorize the instrument in Level 2. We categorize derivatives in Level 3 when we use an aggregate pricing service or published prices that represent a consensus reporting of multiple brokers.

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

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

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

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

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

**Cash Flow Hedges**

The interest rate swap agreements expire through January 2020. The power purchase swap agreement expires in September 2015. The after-tax unrealized gains and losses on cash flow hedge activities and amounts reclassified to earnings are reported in the statements of other comprehensive income and Note 16. The loss expected to be reclassified to earnings within the next twelve months is estimated to be $4 million.

**Financial Impact of Energy Contracts**

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

| | UNS Energy | | | TEP | | |
|---|---|---|---|---|---|---|
| | Years Ended December 31, | | | | | |
| | 2013 | 2012 | 2011 | 2013 | 2012 | 2011 |
| | Millions of Dollars | | | | | |
| Increase (Decrease) to Regulatory Assets/Liabilities | $ (9) | $ (21) | $ 2 | $ — | $ (6) | $ 2 |

Realized gains and losses on settled contracts are fully recoverable through the PPFAC or PGA. At December 31, 2013, UNS Energy and TEP have energy contracts that will settle through the fourth quarter of 2016.

**Derivative Volumes**

The volumes associated with our energy contracts were as follows:

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | December 31, 2013 | December 31, 2012 | December 31, 2013 | December 31, 2012 |
| Power Contracts GWh | 1,583 | 2,228 | 779 | 820 |
| Gas Contracts GBtu | 33,371 | 17,851 | 9,615 | 7,958 |

**Level 3 Fair Value Measurements**

| | Valuation Approach | Fair Value at December 31, 2013 Assets | Fair Value at December 31, 2013 Liabilities | Unobservable Inputs | Range of Unobservable Input |
|---|---|---|---|---|---|
| | | Millions of Dollars | | | |
| **Forward Contracts(1)** | Market approach | $ 1 | $ (4) | Market price per MWh | $ 26.54 - $ 51.75 |
| **Option Contracts(2)** | Option model | 3 | (2) | Market Price per MMbtu | $ 3.87 - $ 4.32 |
| | | | | Gas Volatility | 25.05% - 35.07% |
| **Level 3 Energy Contracts** | | $ 4 | $ (6) | | |

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

(1) TEP comprises $1 million of the forward contract assets and $3 million of the forward contract liabilities.
(2) TEP comprises less than $1 million of the option contract assets.

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

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

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

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

## 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 non-performance by counterparties pursuant to the terms of their contractual obligations. We 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 subsequent measurement at fair value.

We have contractual agreements for energy procurement and hedging activities that contain certain provisions requiring each company to post collateral under certain circumstances. These circumstances include: exposures in excess of unsecured credit limits provided to TEP, UNS Electric, or UNS Gas; credit rating downgrades; or a failure to meet certain financial ratios. In the event that such credit events were to occur, we would have to provide certain credit enhancements in the form of cash or LOCs to fully collateralize our exposure to these counterparties.

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.

Material adverse changes could trigger credit risk-related contingent features. At December 31, 2013, the fair value of derivative instruments in a net liability position under contracts with credit risk-related contingent features was $21 million for UNS Energy and $5 million for TEP. The additional collateral to be posted if credit-risk contingent features were triggered would be $21 million for UNS Energy and $5 million for TEP.

## FINANCIAL INSTRUMENTS NOT CARRIED AT FAIR VALUE

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

- The carrying amounts of our current assets, current liabilities, including current maturities of long-term debt, and amounts outstanding under our credit agreements approximate the fair values due to the short-term nature of these financial instruments. These items have been excluded from the table below.
- For Investment in Lease Debt, we calculated the present value of remaining cash flows using current market rates for instruments with similar characteristics such as credit rating and time-to-maturity. We also incorporated the impact of counterparty credit risk using market credit default swap data. TEP's Investment in Lease Debt matured in January 2013.
- For Investment in Lease Equity, we estimate the price at which an investor would realize a target internal rate of return. Our estimates include: the mix of debt and equity an investor would use to finance the purchase; the cost of debt; the required return on equity; and income tax rates. The estimate assumes a residual value based on an appraisal of Springerville Unit 1 conducted in 2011.
- For Long-Term Debt, we use quoted market prices, when available, or calculate the present value of remaining cash flows at the balance sheet date. When calculating present value, we use current market rates for bonds with similar characteristics such as credit rating and time-to-maturity. We consider the principal amounts of variable rate debt outstanding to be reasonable estimates of the fair value. We also incorporate the impact of our own credit risk using a credit default swap rate.

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

| | Fair Value Hierarchy | December 31, 2013 Carrying Value | December 31, 2013 Fair Value | December 31, 2012 Carrying Value | December 31, 2012 Fair Value |
|---|---|---|---|---|---|
| | | Millions of Dollars | | | |
| **Assets:** | | | | | |
| TEP Investment in Lease Debt | Level 2 | $ — | $ — | $ 9 | $ 9 |
| TEP Investment in Lease Equity | Level 3 | 36 | 25 | 36 | 23 |
| **Liabilities:** | | | | | |
| Long-Term Debt | | | | | |
| UNS Energy | Level 2 | 1,507 | 1,521 | 1,498 | 1,583 |
| TEP | Level 2 | 1,223 | 1,214 | 1,223 | 1,271 |

## NOTE 16. CHANGES IN ACCUMULATED OTHER COMPREHENSIVE INCOME BY COMPONENT

The realized changes in AOCI by component are as follows:

| Details About Accumulated Other Comprehensive Income Components | Amount Reclassified from Other Comprehensive Income – UNS Energy | Amount Reclassified from Other Comprehensive Income – TEP | Affected Line Item in the Income Statement |
|---|---|---|---|
| | Year Ended December 31, 2013 | | |
| | Thousands of Dollars | | |
| Realized Losses on Cash Flow Hedges | | | |
| Interest Rate Swaps - Debt | $ (1,377) | $ (1,166) | Interest Expense Long-Term Debt |
| Interest Rate Swaps - Capital Leases | (2,429) | (2,429) | Interest Expense Capital Leases |
| Commodity Contracts | (747) | (747) | Purchased Energy/Purchased Power |
| Tax Benefit | 1,801 | 1,718 | |
| Realized Losses on Cash Flow Hedges, Net of Taxes | (2,752) | (2,624) | |
| Amortization of SERP and Defined Benefit Plans | | | |
| Prior Service Costs | (1,488) | (1,488) | Other Expense |
| Tax Benefit | 572 | 572 | |
| Amortization, Net of Taxes | (916) | (916) | |
| Total Reclassifications from Other Comprehensive Income for the Period | $ (3,668) | $ (3,540) | |

## NOTE 17. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board (FASB) issued guidance for the recognition, measurement, and disclosure of certain obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date. On adoption, an entity would recognize and disclose in the financial statements its obligation from a joint and several liability arrangement as the sum of the amount the entity agreed with its co-obligors that it will pay, and any additional amount the entity expects to pay on behalf of its co-obligors. This guidance will be effective in the first quarter of 2014. We do not expect the adoption of this guidance to have a material impact on our financial condition, results of operations, or cash flows.

The FASB issued guidance which permits an entity to designate the Federal Funds Rate (the interest rate at which depository institutions lend balances to each other overnight) as a benchmark interest rate for fair value and cash flow hedges. Prior to this guidance, only interest rates on direct treasury obligations of the U.S. Government and the LIBOR were considered benchmark interest rates in the U.S. This guidance is effective immediately, and can be applied prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. We have not entered into any new cash flow or fair value hedges since the effective date of this guidance. We do not expect this guidance to have a material impact on our financial condition, results of operations, or cash flows.

The FASB issued new guidance on the financial statement presentation of unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. We will be required to comply with the guidance on a prospective basis beginning in the first quarter of 2014. Although adoption of this new guidance may impact how such items are classified on our balance sheets, we do not expect such change to be material. In addition, we do not expect any material changes in the presentations of our other financial statements.

## NOTE 18. 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 while UNS Gas' sales generally peak during the winter. Accordingly, comparisons among quarters of a year may not represent overall trends and changes in operations.

| | UNS Energy | | | |
|---|---|---|---|---|
| | First | Second | Third | Fourth |
| | Thousands of Dollars (Except Per Share Amounts) | | | |
| **2013** | | | | |
| Operating Revenue | $ 332,141 | $ 365,217 | $ 437,041 | $ 350,161 |
| Operating Income | 39,895 | 60,803 | 129,765 | 41,033 |
| Net Income | 11,345 | 34,618 | 67,990 | 13,525 |
| Basic EPS | 0.27 | 0.83 | 1.63 | 0.32 |
| Diluted EPS | 0.27 | 0.83 | 1.62 | 0.32 |
| **2012** | | | | |
| Operating Revenue | $ 315,387 | $ 363,998 | $ 434,108 | $ 348,273 |
| Operating Income [(1)] | 34,403 | 68,065 | 106,409 | 42,918 |
| Net Income | 6,476 | 26,273 | 50,664 | 7,506 |
| Basic EPS | 0.17 | 0.65 | 1.22 | 0.18 |
| Diluted EPS | 0.17 | 0.64 | 1.21 | 0.18 |

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.

| | TEP | | | |
|---|---|---|---|---|
| | First | Second | Third | Fourth |
| | Thousands of Dollars | | | |
| **2013** | | | | |
| Operating Revenue | $ 247,751 | $ 304,263 | $ 371,239 | $ 273,437 |
| Operating Income | 22,747 | 53,433 | 123,177 | 31,014 |
| Net Income | 1,478 | 30,787 | 64,167 | 4,910 |
| **2012** | | | | |
| Operating Revenue | $ 223,978 | $ 299,419 | $ 366,910 | $ 271,353 |
| Operating Income [(1)] | 17,898 | 58,211 | 94,079 | 30,299 |
| Net Income (Loss) | (1,461) | 21,910 | 44,569 | 452 |

[(1)] Immaterial variances from quarterly amounts previously reported result from line item reclassifications.

# SCHEDULE C

## UNS Energy Corporation and Tucson Electric Power Company

## Unaudited Interim Consolidated Financial Statements

## Three and Six Months Ended June 30, 2014

**UNS ENERGY CORPORATION**
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

| Three Months Ended June 30, 2014 | Three Months Ended June 30, 2013 | | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|---|---|
| (Unaudited) Thousands of Dollars (Except Per Share Amounts) | | | (Unaudited) Thousands of Dollars (Except Per Share Amounts) | |
| | | **Operating Revenues** | | |
| **$ 302,975** | $ 285,419 | Electric Retail Sales | **$ 527,545** | $ 506,279 |
| **33,309** | 30,654 | Electric Wholesale Sales | **76,730** | 65,052 |
| **21,911** | 20,013 | Gas Retail Sales | **60,481** | 71,002 |
| **28,411** | 29,131 | Other Revenues | **55,242** | 55,025 |
| **386,606** | 365,217 | **Total Operating Revenues** | **719,998** | 697,358 |
| | | **Operating Expenses** | | |
| **69,418** | 86,459 | Fuel | **137,253** | 168,148 |
| **84,060** | 57,796 | Purchased Energy | **153,843** | 121,955 |
| **6,142** | 4,521 | Transmission and Other PPFAC Recoverable Costs | **12,670** | 7,707 |
| **(12,517)** | 2,074 | Increase (Decrease) to Reflect PPFAC/PGA Recovery Treatment | **(21,437)** | (3,294) |
| **147,103** | 150,850 | **Total Fuel and Purchased Energy** | **282,329** | 294,516 |
| **91,621** | 95,143 | Operations and Maintenance | **185,057** | 185,043 |
| **39,563** | 36,671 | Depreciation | **78,644** | 72,970 |
| **6,455** | 8,119 | Amortization | **12,631** | 16,408 |
| **14,942** | 13,631 | Taxes Other Than Income Taxes | **29,750** | 27,723 |
| **299,684** | 304,414 | **Total Operating Expenses** | **588,411** | 596,660 |
| **86,922** | 60,803 | **Operating Income** | **131,587** | 100,698 |
| | | **Other Income (Deductions)** | | |
| **169** | 19 | Interest Income | **249** | 28 |
| **2,538** | 1,734 | Other Income | **4,680** | 3,502 |
| **(958)** | (807) | Other Expense | **(1,688)** | (1,380) |
| **624** | 94 | Appreciation in Fair Value of Investments | **879** | 1,133 |
| **2,373** | 1,040 | **Total Other Income (Deductions)** | **4,120** | 3,283 |
| | | **Interest Expense** | | |
| **19,167** | 17,700 | Long-Term Debt | **37,055** | 35,954 |
| **3,925** | 6,249 | Capital Leases | **7,846** | 12,498 |
| **307** | 346 | Other Interest Expense | **790** | (47) |
| **(1,295)** | (745) | Interest Capitalized | **(2,318)** | (1,420) |
| **22,104** | 23,550 | **Total Interest Expense** | **43,373** | 46,985 |
| **67,191** | 38,293 | **Income Before Income Taxes** | **92,334** | 56,996 |
| **24,837** | 3,675 | Income Tax Expense | **34,505** | 11,033 |
| **$ 42,354** | $ 34,618 | **Net Income** | **$ 57,829** | $ 45,963 |
| | | **Weighted-Average Shares of Common Stock Outstanding (000)** | | |
| **41,781** | 41,598 | Basic | **41,759** | 41,569 |
| **42,145** | 41,921 | Diluted | **42,115** | 41,898 |
| | | **Earnings Per Share** | | |
| **$ 1.01** | $ 0.83 | Basic | **$ 1.38** | $ 1.11 |
| **$ 1.01** | $ 0.83 | Diluted | **$ 1.37** | $ 1.10 |
| **$ 0.480** | $ 0.435 | **Dividends Declared Per Share** | **$ 0.960** | $ 0.870 |

See Notes to Condensed Consolidated Financial Statements.

**UNS ENERGY CORPORATION**
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

| Three Months Ended June 30, 2014 | Three Months Ended June 30, 2013 | | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|---|---|
| (Unaudited) | | | (Unaudited) | |
| Thousands of Dollars | | | Thousands of Dollars | |
| | | **Comprehensive Income** | | |
| **$ 42,354** | $ 34,618 | Net Income | **$ 57,829** | $ 45,963 |
| | | **Other Comprehensive Income** | | |
| | | Net Changes in Fair Value of Cash Flow Hedges: | | |
| **517** | 933 | net of income tax expense of $335 and $610 | | |
| | | net of income tax expense of $691 and $1,009 | **1,010** | 1,544 |
| | | Supplemental Executive Retirement Plan (SERP) Benefit Amortization: | | |
| **25** | 68 | net of income tax expense of $15 and $43 | | |
| | | net of income tax expense of $30 and $85 | **49** | 137 |
| **542** | 1,001 | **Total Other Comprehensive Income, Net of Tax** | **1,059** | 1,681 |
| **$ 42,896** | $ 35,619 | **Total Comprehensive Income** | **$ 58,888** | $ 47,644 |

See Notes to Condensed Consolidated Financial Statements.

**UNS ENERGY CORPORATION**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

| | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|
| | (Unaudited) | |
| | Thousands of Dollars | |
| **Cash Flows from Operating Activities** | | |
| Cash Receipts from Electric Retail Sales | **$ 531,439** | $ 519,154 |
| Cash Receipts from Electric Wholesale Sales | **89,741** | 82,273 |
| Cash Receipts from Gas Retail Sales | **80,348** | 91,207 |
| Cash Receipts from Operating Springerville Units 3 & 4 | **47,099** | 49,974 |
| Cash Receipts from Gas Wholesale Sales | **2,287** | 3,494 |
| Income Tax Refunds Received | **472** | — |
| Interest Received | **7** | 516 |
| Other Cash Receipts | **22,812** | 16,914 |
| Purchased Energy Costs Paid | **(152,982)** | (135,775) |
| Payment of Operations and Maintenance Costs | **(138,692)** | (121,272) |
| Fuel Costs Paid | **(135,128)** | (140,185) |
| Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized | **(86,695)** | (90,554) |
| Wages Paid, Net of Amounts Capitalized | **(72,237)** | (68,004) |
| Interest Paid, Net of Amounts Capitalized | **(31,446)** | (34,662) |
| Capital Lease Interest Paid | **(15,888)** | (18,630) |
| Other Cash Payments | **(3,380)** | (6,798) |
| **Net Cash Flows—Operating Activities** | **137,757** | 147,652 |
| **Cash Flows from Investing Activities** | | |
| Capital Expenditures | **(186,037)** | (155,685) |
| Return of Investments in Springerville Lease Debt | **—** | 9,104 |
| Other, net | **(4,345)** | (3,613) |
| **Net Cash Flows—Investing Activities** | **(190,382)** | (150,194) |
| **Cash Flows from Financing Activities** | | |
| Proceeds from Borrowings Under Revolving Credit Facilities | **151,000** | 114,000 |
| Repayments of Borrowings Under Revolving Credit Facilities | **(129,000)** | (48,000) |
| Proceeds from Issuance of Long-Term Debt | **149,168** | — |
| Payments of Capital Lease Obligations | **(83,204)** | (84,206) |
| Common Stock Dividends Paid | **(40,034)** | (36,079) |
| Payment of Debt Issue/Retirement Costs | **(1,641)** | (982) |
| Proceeds from Stock Options Exercised | **595** | — |
| Other, net | **543** | 3,584 |
| **Net Cash Flows—Financing Activities** | **47,427** | (51,683) |
| **Net Increase (Decrease) in Cash and Cash Equivalents** | **(5,198)** | (54,225) |
| **Cash and Cash Equivalents, Beginning of Year** | **74,878** | 123,918 |
| **Cash and Cash Equivalents, End of Period** | **$ 69,680** | $ 69,693 |

See Note 11 for supplemental cash flow information.

See Notes to Condensed Consolidated Financial Statements.

**UNS ENERGY CORPORATION**
**CONDENSED CONSOLIDATED BALANCE SHEETS**

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| | (Unaudited) | |
| | Thousands of Dollars | |
| **ASSETS** | | |
| **Utility Plant** | | |
| Plant in Service | **$ 5,392,666** | $ 5,192,122 |
| Utility Plant Under Capital Leases | **747,158** | 637,957 |
| Construction Work in Progress | **186,249** | 201,959 |
| **Total Utility Plant** | **6,326,073** | 6,032,038 |
| Less Accumulated Depreciation and Amortization | **(2,078,626)** | (1,982,524) |
| Less Accumulated Amortization of Capital Lease Assets | **(525,327)** | (514,677) |
| **Total Utility Plant—Net** | **3,722,120** | 3,534,837 |
| **Investments and Other Property** | | |
| Investments in Lease Equity | **36,122** | 36,194 |
| Other | **35,551** | 34,971 |
| **Total Investments and Other Property** | **71,673** | 71,165 |
| **Current Assets** | | |
| Cash and Cash Equivalents | **69,680** | 74,878 |
| Accounts Receivable—Customer | **114,276** | 104,596 |
| Unbilled Accounts Receivable | **67,637** | 52,403 |
| Allowance for Doubtful Accounts | **(7,001)** | (6,833) |
| Materials and Supplies | **92,771** | 88,085 |
| Deferred Income Taxes—Current | **86,401** | 66,906 |
| Regulatory Assets—Current | **69,322** | 52,763 |
| Fuel Inventory | **44,044** | 44,317 |
| Derivative Instruments | **9,850** | 5,629 |
| Other | **17,453** | 15,354 |
| **Total Current Assets** | **564,433** | 498,098 |
| **Regulatory and Other Assets** | | |
| Regulatory Assets—Noncurrent | **162,263** | 150,584 |
| Derivative Instruments | **1,528** | 1,180 |
| Other Assets | **26,575** | 24,430 |
| **Total Regulatory and Other Assets** | **190,366** | 176,194 |
| **Total Assets** | **$ 4,548,592** | $ 4,280,294 |

See Notes to Condensed Consolidated Financial Statements.

**(Continued)**

**UNS ENERGY CORPORATION**
**CONDENSED CONSOLIDATED BALANCE SHEETS**

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| | (Unaudited) | |
| | Thousands of Dollars | |
| **CAPITALIZATION AND OTHER LIABILITIES** | | |
| **Capitalization** | | |
| Common Stock Equity | **$ 1,149,578** | $ 1,130,784 |
| Capital Lease Obligations | **69,938** | 131,370 |
| Long-Term Debt | **1,677,323** | 1,507,070 |
| **Total Capitalization** | **2,896,839** | 2,769,224 |
| **Current Liabilities** | | |
| Current Obligations Under Capital Leases | **272,939** | 186,056 |
| Borrowings Under Revolving Credit Facilities | **23,000** | 22,000 |
| Accounts Payable—Trade | **104,720** | 117,503 |
| Regulatory Liabilities—Current | **54,384** | 53,935 |
| Accrued Taxes Other than Income Taxes | **47,601** | 43,880 |
| Customer Deposits | **28,066** | 30,671 |
| Accrued Employee Expenses | **23,202** | 28,148 |
| Accrued Interest | **29,637** | 27,786 |
| Derivative Instruments | **6,435** | 7,534 |
| Other | **22,536** | 17,775 |
| **Total Current Liabilities** | **612,520** | 535,288 |
| **Deferred Credits and Other Liabilities** | | |
| Deferred Income Taxes—Noncurrent | **528,636** | 488,887 |
| Regulatory Liabilities—Noncurrent | **326,388** | 302,482 |
| Pension and Other Retiree Benefits | **90,984** | 90,923 |
| Derivative Instruments | **5,976** | 7,100 |
| Other | **87,249** | 86,390 |
| **Total Deferred Credits and Other Liabilities** | **1,039,233** | 975,782 |
| **Commitments, Contingencies, and Environmental Matters (Note 6)** | | |
| **Total Capitalization and Other Liabilities** | **$ 4,548,592** | $ 4,280,294 |

See Notes to Condensed Consolidated Financial Statements.

**(Concluded)**

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

| | Common Shares Outstanding * | Common Stock | Retained Earnings | Accumulated Other Comprehensive Loss | Total Stockholders' Equity |
|---|---|---|---|---|---|
| | | | (Unaudited) | | |
| | Thousands of Shares | | Thousands of Dollars | | |
| **Balances at December 31, 2013** | **41,538** | **$ 889,301** | **$ 247,532** | **$ (6,049)** | **$ 1,130,784** |
| Net Income | | | 57,829 | | 57,829 |
| Other Comprehensive Income, net of tax | | | | 1,059 | 1,059 |
| Dividends Declared | | | (40,372) | | (40,372) |
| Shares Issued for Stock Options | 20 | 594 | | | 594 |
| Shares Issued under Performance Share Awards | 101 | — | | | — |
| Share-based Compensation | | (316) | | | (316) |
| **Balances at June 30, 2014** | **41,659** | **$ 889,579** | **$ 264,989** | **$ (4,990)** | **$ 1,149,578** |

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

See Notes to Condensed Consolidated Financial Statements.

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

| Three Months Ended June 30, 2014 | Three Months Ended June 30, 2013 | | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|---|---|
| (Unaudited) | | | (Unaudited) | |
| Thousands of Dollars | | | Thousands of Dollars | |
| | | **Operating Revenues** | | |
| **$ 257,790** | $ 243,635 | Electric Retail Sales | **$ 443,805** | $ 428,515 |
| **32,555** | 29,542 | Electric Wholesale Sales | **74,639** | 63,940 |
| **31,273** | 31,086 | Other Revenues | **58,687** | 59,559 |
| **321,618** | 304,263 | **Total Operating Revenues** | **577,131** | 552,014 |
| | | **Operating Expenses** | | |
| **68,334** | 84,553 | Fuel | **135,964** | 165,351 |
| **52,906** | 28,410 | Purchased Power | **75,521** | 47,338 |
| **3,552** | 1,730 | Transmission and Other PPFAC Recoverable Costs | **7,461** | 2,595 |
| **(13,061)** | 5,274 | Increase (Decrease) to Reflect PPFAC Recovery Treatment | **(14,791)** | 2,914 |
| **111,731** | 119,967 | **Total Fuel and Purchased Energy** | **204,155** | 218,198 |
| **79,772** | 82,011 | Operations and Maintenance | **161,117** | 159,835 |
| **31,080** | 28,861 | Depreciation | **61,891** | 57,418 |
| **7,377** | 9,052 | Amortization | **14,476** | 18,275 |
| **12,005** | 10,939 | Taxes Other Than Income Taxes | **23,840** | 22,108 |
| **241,965** | 250,830 | **Total Operating Expenses** | **465,479** | 475,834 |
| **79,653** | 53,433 | **Operating Income** | **111,652** | 76,180 |
| | | **Other Income (Deductions)** | | |
| **165** | 12 | Interest Income | **174** | 8 |
| **2,187** | 1,270 | Other Income | **4,099** | 2,438 |
| **(2,694)** | (2,472) | Other Expense | **(4,809)** | (4,717) |
| **624** | 94 | Appreciation in Fair Value of Investments | **879** | 1,133 |
| **282** | (1,096) | **Total Other Income (Deductions)** | **343** | (1,138) |
| | | **Interest Expense** | | |
| **15,507** | 13,991 | Long-Term Debt | **29,747** | 28,564 |
| **3,925** | 6,249 | Capital Leases | **7,846** | 12,498 |
| **140** | 192 | Other Interest Expense | **453** | (168) |
| **(1,104)** | (534) | Interest Capitalized | **(2,028)** | (1,027) |
| **18,468** | 19,898 | **Total Interest Expense** | **36,018** | 39,867 |
| **61,467** | 32,439 | **Income Before Income Taxes** | **75,977** | 35,175 |
| **22,742** | 1,652 | Income Tax Expense | **28,080** | 2,909 |
| **$ 38,725** | $ 30,787 | **Net Income** | **$ 47,897** | $ 32,266 |

See Notes to Condensed Consolidated Financial Statements.

## TUCSON ELECTRIC POWER COMPANY
## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

| Three Months Ended June 30, 2014 | Three Months Ended June 30, 2013 | | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|---|---|
| (Unaudited) | | | (Unaudited) | |
| Thousands of Dollars | | | Thousands of Dollars | |
| | | **Comprehensive Income** | | |
| **$ 38,725** | $ 30,787 | Net Income | **$ 47,897** | $ 32,266 |
| | | **Other Comprehensive Income** | | |
| | | Net Changes in Fair Value of Cash Flow Hedges: | | |
| **494** | 878 | net of income tax expense of $321 and $574 | | |
| | | net of income tax expense of $667 and $952 | **975** | 1,456 |
| | | SERP Benefit Amortization: | | |
| **25** | 68 | net of income tax expense of $15 and $43 | | |
| | | net of income tax expense of $30 and $85 | **49** | 137 |
| **519** | 946 | **Total Other Comprehensive Income, Net of Tax** | **1,024** | 1,593 |
| **$ 39,244** | $ 31,733 | **Total Comprehensive Income** | **$ 48,921** | $ 33,859 |

See Notes to Condensed Consolidated Financial Statements.

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

| | Six Months Ended June 30, | |
|---|---|---|
| | 2014 | 2013 |
| | (Unaudited) | |
| | Thousands of Dollars | |
| **Cash Flows from Operating Activities** | | |
| Cash Receipts from Electric Retail Sales | **$ 444,624** | $ 435,779 |
| Cash Receipts from Electric Wholesale Sales | **86,087** | 75,803 |
| Cash Receipts from Operating Springerville Units 3 & 4 | **47,099** | 49,974 |
| Reimbursement of Affiliate Charges | **13,633** | 12,695 |
| Cash Receipts from Gas Wholesale Sales | **46** | 3,145 |
| Income Tax Refunds Received | **9** | — |
| Interest Received | **5** | 509 |
| Other Cash Receipts | **19,580** | 13,320 |
| Payment of Operations and Maintenance Costs | **(134,606)** | (117,133) |
| Fuel Costs Paid | **(134,374)** | (139,596) |
| Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized | **(66,588)** | (68,574) |
| Wages Paid, Net of Amounts Capitalized | **(60,845)** | (57,483) |
| Purchased Power Costs Paid | **(59,088)** | (40,949) |
| Interest Paid, Net of Amounts Capitalized | **(24,588)** | (27,590) |
| Capital Lease Interest Paid | **(15,888)** | (18,630) |
| Other Cash Payments | **(2,064)** | (5,728) |
| **Net Cash Flows—Operating Activities** | **113,042** | 115,542 |
| **Cash Flows from Investing Activities** | | |
| Capital Expenditures | **(157,161)** | (118,210) |
| Return of Investments in Springerville Lease Debt | **—** | 9,104 |
| Other, net | **(3,460)** | (3,470) |
| **Net Cash Flows—Investing Activities** | **(160,621)** | (112,576) |
| **Cash Flows from Financing Activities** | | |
| Proceeds from Borrowings Under Revolving Credit Facility | **105,000** | 78,000 |
| Repayments of Borrowings Under Revolving Credit Facility | **(105,000)** | (48,000) |
| Proceeds from Issuance of Long-Term Debt | **149,168** | — |
| Payments of Capital Lease Obligations | **(83,204)** | (84,206) |
| Payment of Debt Issue/Retirement Costs | **(1,641)** | (982) |
| Other, net | **656** | 596 |
| **Net Cash Flows—Financing Activities** | **64,979** | (54,592) |
| **Net Increase (Decrease) in Cash and Cash Equivalents** | **17,400** | (51,626) |
| **Cash and Cash Equivalents, Beginning of Year** | **25,335** | 79,743 |
| **Cash and Cash Equivalents, End of Period** | **$ 42,735** | $ 28,117 |

See Note 11 for supplemental cash flow information.

See Notes to Condensed Consolidated Financial Statements.

**TUCSON ELECTRIC POWER COMPANY**
**CONDENSED CONSOLIDATED BALANCE SHEETS**

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| | (Unaudited) | |
| | Thousands of Dollars | |
| **ASSETS** | | |
| **Utility Plant** | | |
| Plant in Service | **$ 4,644,399** | $ 4,467,667 |
| Utility Plant Under Capital Leases | **747,158** | 637,957 |
| Construction Work in Progress | **169,459** | 180,485 |
| **Total Utility Plant** | **5,561,016** | 5,286,109 |
| Less Accumulated Depreciation and Amortization | **(1,913,655)** | (1,826,977) |
| Less Accumulated Amortization of Capital Lease Assets | **(525,327)** | (514,677) |
| **Total Utility Plant—Net** | **3,122,034** | 2,944,455 |
| **Investments and Other Property** | | |
| Investments in Lease Equity | **36,122** | 36,194 |
| Other | **34,192** | 33,488 |
| **Total Investments and Other Property** | **70,314** | 69,682 |
| **Current Assets** | | |
| Cash and Cash Equivalents | **42,735** | 25,335 |
| Accounts Receivable—Customer | **96,513** | 80,211 |
| Unbilled Accounts Receivable | **56,252** | 34,369 |
| Allowance for Doubtful Accounts | **(4,977)** | (4,825) |
| Accounts Receivable—Due from Affiliates | **2,818** | 6,064 |
| Materials and Supplies | **79,409** | 75,200 |
| Deferred Income Taxes—Current | **91,585** | 70,722 |
| Fuel Inventory | **43,754** | 44,027 |
| Regulatory Assets—Current | **59,091** | 42,555 |
| Derivative Instruments | **4,289** | 2,137 |
| Other | **14,864** | 12,923 |
| **Total Current Assets** | **486,333** | 388,718 |
| **Regulatory and Other Assets** | | |
| Regulatory Assets—Noncurrent | **152,259** | 141,030 |
| Derivative Instruments | **493** | 167 |
| Other Assets | **21,093** | 19,233 |
| **Total Regulatory and Other Assets** | **173,845** | 160,430 |
| **Total Assets** | **$ 3,852,526** | $ 3,563,285 |

See Notes to Condensed Consolidated Financial Statements.

**(Continued)**

**TUCSON ELECTRIC POWER COMPANY**
**CONDENSED CONSOLIDATED BALANCE SHEETS**

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| | (Unaudited) | |
| | Thousands of Dollars | |
| **CAPITALIZATION AND OTHER LIABILITIES** | | |
| **Capitalization** | | |
| Common Stock Equity | **$ 974,844** | $ 925,923 |
| Capital Lease Obligations | **69,938** | 131,370 |
| Long-Term Debt | **1,372,323** | 1,223,070 |
| **Total Capitalization** | **2,417,105** | 2,280,363 |
| **Current Liabilities** | | |
| Current Obligations Under Capital Leases | **272,939** | 186,056 |
| Accounts Payable—Trade | **89,162** | 88,556 |
| Accounts Payable—Due to Affiliates | **5,282** | 9,153 |
| Accrued Taxes Other than Income Taxes | **39,732** | 34,485 |
| Accrued Employee Expenses | **19,726** | 24,454 |
| Regulatory Liabilities—Current | **28,075** | 23,701 |
| Accrued Interest | **24,651** | 22,785 |
| Customer Deposits | **20,906** | 21,354 |
| Derivative Instruments | **4,261** | 5,531 |
| Other | **13,641** | 9,244 |
| **Total Current Liabilities** | **518,375** | 425,319 |
| **Deferred Credits and Other Liabilities** | | |
| Deferred Income Taxes—Noncurrent | **464,983** | 428,103 |
| Regulatory Liabilities—Noncurrent | **283,475** | 263,270 |
| Pension and Other Retiree Benefits | **84,724** | 84,936 |
| Derivative Instruments | **4,907** | 5,161 |
| Other | **78,957** | 76,133 |
| **Total Deferred Credits and Other Liabilities** | **917,046** | 857,603 |
| **Commitments, Contingencies, and Environmental Matters (Note 6)** | | |
| **Total Capitalization and Other Liabilities** | **$ 3,852,526** | $ 3,563,285 |

See Notes to Condensed Consolidated Financial Statements.

**(Concluded)**

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

| | Common Stock | Capital Stock Expense | Retained Earnings | Accumulated Other Comprehensive Loss | Total Stockholder's Equity |
|---|---|---|---|---|---|
| | | | (Unaudited) | | |
| | | | Thousands of Dollars | | |
| **Balances at December 31, 2013** | **$ 888,971** | **$ (6,357)** | **$ 49,185** | **$ (5,876)** | **$ 925,923** |
| Net Income | | | 47,897 | | 47,897 |
| Other Comprehensive Income, net of tax | | | | 1,024 | 1,024 |
| **Balances at June 30, 2014** | **$ 888,971** | **$ (6,357)** | **$ 97,082** | **$ (4,852)** | **$ 974,844** |

See Notes to Condensed Consolidated Financial Statements.

## NOTE 1. NATURE OF OPERATIONS AND FINANCIAL STATEMENT PRESENTATION

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

We prepared our condensed consolidated financial statements according to generally accepted accounting principles in the United States of America (GAAP) and the Securities and Exchange Commission's (SEC) interim reporting requirements. These condensed consolidated financial statements exclude some information and footnotes required by GAAP and the SEC for annual financial statement reporting. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes in our 2013 Annual Report on Form 10-K.

The condensed consolidated financial statements are unaudited, but, in management's opinion, include all recurring adjustments necessary for a fair presentation of the results for the interim periods presented. Because weather and other factors cause seasonal fluctuations in sales, our quarterly results are not indicative of annual operating results. UNS Energy and TEP reclassified certain amounts in the financial statements to conform to current year presentation.

### REVISION OF PRIOR PERIOD BALANCE SHEETS

UNS Energy and TEP revised their December 31, 2013 balance sheets to correct an error in the classification of capital lease obligations and related deferred income taxes. The correction increased current capital lease obligations and decreased noncurrent capital lease obligations by $18 million and increased current deferred tax assets and noncurrent deferred tax liabilities by $7 million. We do not believe the misclassification was material to the previously issued financial statements.

### RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

In 2014, we adopted accounting guidance that:

- requires an entity to recognize and disclose in the financial statements its obligation from a joint and several liability arrangement as the sum of the amount the entity agreed with its co-obligors that it will pay and any additional amount the entity expects to pay on behalf of its co-obligors. The adoption of this guidance did not have a material impact on our disclosures, financial condition, results of operations, or cash flows.
- impacts the financial statement presentation of unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. Although adoption and prospective application of this guidance impacted how such items are classified on our balance sheets, such change was not material. Additionally, there were no material changes in our results of operations or cash flows.

## NOTE 2. PENDING MERGER WITH FORTIS

On December 11, 2013, UNS Energy announced that it had entered into an Agreement and Plan of Merger (Merger), subject to shareholder and required regulatory approvals, to be acquired by Fortis Inc. (Fortis) for $60.25 per share of Common Stock in cash. Following the Merger, UNS Energy will continue as a wholly owned subsidiary of Fortis. The Boards of Directors of each of UNS Energy and Fortis have approved the Merger.

The following additional approvals have been received:

- In March 2014, UNS Energy's shareholders approved the Merger;
- In April 2014, the Federal Energy Regulatory Commission (FERC) approved the Merger;
- In May 2014, the Committee on Foreign Investment in the United States concluded its review determining there are no unresolved national security concerns with respect to the Merger;
- In June 2014, the United States Federal Trade Commission granted UNS Energy's request for early termination of the waiting period with respect to the Merger under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended; and

- In July 2014, the Federal Communications Commission approved UNS Energy's FCC license transfer of control applications with respect to the Merger.

The final regulatory approval necessary to complete the Merger is approval by the Arizona Corporation Commission (ACC). In May 2014, UNS Energy, Fortis, ACC Staff, the Residential Utility Consumer Office, and other parties to the Merger proceedings entered into a settlement (Settlement) in which the parties agree that the Merger is in the public interest and recommend approval by the ACC, subject to certain conditions. Those conditions include, but are not limited to, the following:

- UNS Energy shall provide credits on the Regulated Utilities retail customers' bills totaling $30 million over five years; $10 million in year one and $5 million annually in years two through five. The monthly bill credits will be applied each year from October through March. If the Merger closes by the end of September 2014, the bill credits will commence on October 1, 2014;
- UNS Energy and the Regulated Utilities will adopt certain ring-fencing and corporate governance provisions;
- Dividends paid from the Regulated Utilities to UNS Energy cannot exceed 60 percent of the Regulated Utilities' respective annual net income for a period of five years or until such time that their respective equity capitalization reaches 50 percent of total capital (excluding any goodwill recorded) as accounted for in accordance with GAAP. The ratios used to determine the dividend restrictions will be calculated for each calendar year and reported to the ACC annually beginning on April 1, 2016. The dividend restrictions were contingent upon receiving necessary consents of the lenders in UNS Energy's credit facility, which consents were obtained in June 2014; and
- Fortis shall make an equity investment totaling $220 million through UNS Energy into the Regulated Utilities following closing of the Merger. However, if the Merger closes after September 30, 2014, the equity investment may be made into UNS Energy to retire debt.

The Settlement is subject to the review and approval of the ACC, which could approve, reject, or require modifications to the Settlement as a condition of approval of the Merger. Hearings before an ACC administrative law judge on the Settlement concluded on June 17, 2014. The Settlement requests that the ACC issue an order approving the Settlement no later than September 18, 2014.

The completion of the Merger is also subject to the absence of any injunction, order, or other law prohibiting the Merger.

If the Merger is approved by the ACC in September 2014 as requested by the parties to the Settlement Agreement, we expect the Merger to close by the end of September 2014. Upon completion of the Merger, UNS Energy expects to record approximately $19 million of merger-related expenses including investment banker fees, legal fees, and accelerated expenses for certain share-based compensation awards. TEP would record approximately $15 million as its allocated share of these merger-related expenses. See Note 9.

## NOTE 3. REGULATORY MATTERS

The ACC and the FERC each regulate portions of the utility accounting practices and rates of the Regulated Utilities.

The ACC regulates rates charged to retail customers, the siting of generation and transmission facilities, the issuance of securities, transactions with affiliated parties, and other utility matters. The ACC also enacts other regulations and policies that can affect business decisions and accounting practices. The FERC regulates terms and prices of transmission services and wholesale electricity sales. The Merger with Fortis is subject to approval by the ACC. See Note 2. Additionally, the purchase of Gila River Generating Station Unit 3 (Gila River Unit 3) remains subject to FERC approval. See Note 7.

### COST RECOVERY MECHANISMS

#### TEP Purchased Power and Fuel Adjustment Clause

In April 2014, the ACC approved a Purchased Power and Fuel Adjustment Clause (PPFAC) rate for TEP of 0.1 cents per kWh for the period May through September 2014 and 0.5 cents per kWh for the period October 2014 through March 2015. TEP's PPFAC rate was a credit of 0.14 cents per kWh for the period July 2013 through April 2014.

In September 2011, a fire at the underground mine providing coal to San Juan Generating Station (San Juan) caused interruptions to mining operations and resulted in increased fuel costs. The 2013 TEP Rate Order required TEP to defer

incremental fuel costs of $10 million from recovery under the PPFAC pending final resolution of an insurance claim by the San Juan Coal Company and distribution of insurance proceeds to San Juan participants. At June 30, 2014, TEP has received insurance settlement proceeds of $8 million. The proceeds offset the deferred costs and are reflected in our cash flow statements as an other operating cash receipt. TEP expects to recover any remaining fuel costs, not reimbursed by insurance, through its PPFAC.

**TEP Environmental Compliance Adjustor**

The 2013 TEP Rate Order provided an Environmental Compliance Adjustor (ECA) to recover the return on and of qualified investments, to comply with environmental standards required by federal or other governmental agencies. The ECA rate of 0.0049 cents per kWh became effective on May 1, 2014. TEP expects to recognize ECA revenues of less than $1 million in 2014.

**UNS Electric Transmission Cost Adjustor**

The 2013 UNS Electric Rate Order provided a Transmission Cost Adjustor (TCA) that allows more timely recovery of transmission costs associated with serving retail customers. The TCA rate is adjusted annually based on information filed with the ACC each May. The TCA rate of 0.114 cents per kWh became effective in June 2014.

**UNS Gas Purchased Gas Adjustor**

In November of 2013, a Purchased Gas Adjustor (PGA) credit of 10 cents per therm became effective for UNS Gas. The credit expired in April 2014.

**Energy Efficiency Standards**

The Regulated Utilities are required to implement cost-effective Demand Side Management (DSM) programs to comply with the ACC's Energy Efficiency (EE) Standards. The EE Standards provide for a DSM surcharge to recover, from retail customers, the costs to implement DSM programs as well as a performance incentive. In the first half of 2014, TEP recorded a DSM performance incentive of $2 million that is included in Electric Retail Sales in the UNS Energy and TEP income statements.

**Lost Fixed Cost Recovery Mechanism**

The Lost Fixed Cost Recovery (LFCR) mechanism provides recovery of certain non-fuel costs that would go unrecovered due to lost retail kWh sales as a result of implementing ACC approved energy efficiency programs and distributed generation targets. During separate rate case proceedings in 2013, the ACC authorized LFCR mechanisms for TEP and UNS Electric, subject to a year-over-year cap of 1% of each company’s respective total retail revenues.

TEP and UNS Electric filed their first LFCR reports with the ACC in May 2014. TEP requested recovery of approximately $5 million and UNS Electric requested recovery of approximately $1 million. The LFCR rates are expected to go into effect in August 2014 for TEP and in September 2014 for UNS Electric.

TEP and UNS Electric recorded LFCR revenues of $6 million and $2 million, respectively, in the first six months of 2014 related to reductions in retail kWh sales due to energy efficiency programs and distributed generation implemented in 2013 and 2014. We recognize LFCR revenue when verifiable regardless of when the lost retail kWh sales occur. LFCR revenue is included in Electric Retail Sales in the income statements.

## NOTE 4. BUSINESS SEGMENTS

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

(1) TEP, a regulated electric utility and our largest subsidiary

(2) UNS Electric, a regulated electric utility

(3) UNS Gas, a regulated gas distribution utility

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

| | Reportable Segments | | | | | |
|---|---|---|---|---|---|---|
| | TEP | UNS Electric | UNS Gas | Other [(2)] | Reconciling Adjustments | UNS Energy |
| | Millions of Dollars | | | | | |
| **Three Months Ended June 30, 2014** | | | | | | |
| Operating Revenues-External | $ 318 | $ 47 | $ 22 | $ — | $ — | $ 387 |
| Operating Revenues-Intersegment [(1)] | 4 | — | 1 | 4 | (9) | — |
| Income Before Income Taxes | 61 | 6 | — | — | — | 67 |
| Net Income | 39 | 4 | — | (1) | — | 42 |
| **Three Months Ended June 30, 2013** | | | | | | |
| Operating Revenues-External | $ 300 | $ 44 | $ 21 | $ — | $ — | $ 365 |
| Operating Revenues-Intersegment [(1)] | 4 | — | 1 | 4 | (9) | — |
| Income Before Income Taxes | 32 | 6 | — | — | — | 38 |
| Net Income | 31 | 4 | — | — | — | 35 |

| | Reportable Segments | | | | | |
|---|---|---|---|---|---|---|
| | TEP | UNS Electric | UNS Gas | Other [(2)] | Reconciling Adjustments | UNS Energy |
| | Millions of Dollars | | | | | |
| **Six Months Ended June 30, 2014** | | | | | | |
| Operating Revenues-External | $ 569 | 87 | 64 | $ — | $ — | $ 720 |
| Operating Revenues-Intersegment [(1)] | 8 | 1 | 1 | 8 | (18) | — |
| Income Before Income Taxes | 76 | 9 | 8 | (1) | — | 92 |
| Net Income | 48 | 6 | 5 | (1) | — | 58 |
| **Six Months Ended June 30, 2013** | | | | | | |
| Operating Revenues-External | $ 543 | $ 80 | $ 73 | $ 1 | $ — | $ 697 |
| Operating Revenues-Intersegment [(1)] | 9 | 1 | 1 | 8 | (19) | — |
| Income Before Income Taxes | 35 | 9 | 13 | — | — | 57 |
| Net Income | 32 | 6 | 8 | — | — | 46 |

(1) Operating Revenues-Intersegment includes common costs (system, facilities, etc.) allocated to affiliates on a cost-causative basis and recorded as revenue by TEP, sales of power between TEP and UNS Electric at third-party market prices, control area services provided by TEP to UNS Electric based on a FERC-approved tariff, sales of gas by UNS Gas at third-party market prices for use in UNS Electric's generating facilities, and supplemental workforce charges (primarily meter reading services) provided to the utilities by an unregulated affiliate.

(2) Other includes the UNS Energy and UES holding companies, Millennium, and UED.

## NOTE 5. DEBT AND CAPITAL LEASE OBLIGATIONS

We summarize below the significant changes to our debt and capital lease obligations from those reported in our 2013 Annual Report on Form 10-K.

### TEP SPRINGERVILLE COAL HANDLING FACILITIES CAPITAL LEASE PURCHASE COMMITMENT

In April 2014, TEP notified the owner participants and their lessors that TEP has elected to purchase their undivided ownership interests in the Springerville Coal Handling Facilities at the fixed purchase price of $120 million upon the expiration of the lease term in April 2015. Due to TEP's purchase commitment, TEP recorded, in April of 2014, an increase to both Utility Plant

Under Capital Leases and Current Obligations Under Capital Leases on its balance sheet in the amount of $109 million, which represented the present value of the total purchase commitment.

TEP previously agreed with Tri-State Generation and Transmission Association, Inc. (Tri-State), the lessee of Springerville Unit 3, and Salt River Project Agricultural Improvement and Power District (SRP), the owner of Springerville Unit 4, that if the Springerville Coal Handling Facilities Leases were not renewed, TEP would exercise the purchase option under those contracts. Upon TEP's purchase, SRP is obligated to buy a portion of the Springerville Coal Handling Facilities from TEP for approximately $24 million, and Tri-State is obligated to either 1) buy a portion of the facilities for approximately $24 million or 2) continue to make payments to TEP for the use of the facilities. No amounts have been recorded for these commitments from SRP and Tri-State at June 30, 2014.

**2014 TEP UNSECURED NOTES ISSUED**

In March 2014, TEP issued $150 million of 5.0% unsecured notes due March 2044. TEP may call the debt prior to September 15, 2043, with a make-whole premium plus accrued interest. After September 15, 2043, TEP may call the debt at par plus accrued interest. TEP used the net proceeds to repay approximately $90 million on the revolving credit facility, with the remaining proceeds to be applied to general corporate purposes. The unsecured notes contain a limitation on the amount of secured debt that TEP may have outstanding.

**TEP CREDIT AGREEMENT**

The TEP Credit Agreement consists of a $200 million revolving credit, revolving LOC facility and an $82 million LOC facility to support tax-exempt bonds. As of June 30, 2014, there is $184 million available under the revolving credit facility. The TEP Credit Agreement expires in November 2016. As of July 18, 2014, TEP had $134 million available under its revolving credit facility.

TEP provided, in the second quarter of 2014, a LOC for $15 million to the seller of Gila River Unit 3 to satisfy a condition of the purchase agreement. TEP's borrowing capacity under the TEP Credit Agreement is reduced by $15 million until the Gila River transaction closes and the LOC is terminated. See Note 7.

**COVENANT COMPLIANCE**

At June 30, 2014, we were in compliance with the terms of our loan and credit agreements.

## NOTE 6. COMMITMENTS, CONTINGENCIES, AND ENVIRONMENTAL MATTERS

**COMMITMENTS**

UNS Energy's commitments represent the obligations of TEP, UNS Electric, and UNS Gas. In addition to those reported in our 2013 Annual Report on Form 10-K, UNS Energy entered into the following long-term commitments through June 30, 2014:

| | UNS Energy Purchase Commitments | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2014 | 2015 | 2016 | 2017 | 2018 | Thereafter | Total |
| | Millions of Dollars | | | | | | |
| Fuel, including Transportation | $ — | $ 9 | $ 9 | $ 9 | $ 8 | $ 8 | $ 43 |
| Purchased Power | — | 23 | — | — | — | — | 23 |
| Capital Lease Obligations[1] | — | 120 | — | — | — | — | 120 |
| **Total Purchase Commitments** | $ — | $ 152 | $ 9 | $ 9 | $ 8 | $ 8 | $ 186 |

TEP entered into the following long-term commitments:

| | TEP Purchase Commitments | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2014 | 2015 | 2016 | 2017 | 2018 | Thereafter | Total |
| | Millions of Dollars | | | | | | |
| Fuel, Including Transportation | $ — | $ 8 | $ 8 | $ 8 | $ 8 | $ 8 | $ 40 |
| Purchased Power | — | 15 | — | — | — | — | 15 |
| Capital Lease Obligations[1] | — | 120 | — | — | — | — | 120 |
| **Total Purchase Commitments** | $ — | $ 143 | $ 8 | $ 8 | $ 8 | $ 8 | $ 175 |

(1) In April 2014, TEP entered into agreements to purchase certain Springerville Coal Handling Facilities leased interests. See Note 5.

**UNS ENERGY CONTINGENCIES**

In May 2014, UNS Energy, Fortis, ACC Staff, the Residential Utility Consumer Office, and other parties to the Merger proceedings entered into a Settlement in which the Regulated Utilities agreed, contingent upon completion of the Merger, to provide credits on retail customers' bills totaling $30 million over five years. See Note 2.

**TEP CONTINGENCIES**

**Planned Purchase of Gas-Fired Generation Facility**

In 2013, TEP and UNS Electric entered into an agreement to purchase a gas-fired generation facility. See Note 7.

**Claim Related to San Juan Generating Station**

San Juan Coal Company (SJCC) operates an underground coal mine in an area where certain gas producers have oil and gas leases with the federal government, the State of New Mexico, and private parties. These gas producers allege that SJCC's underground coal mine interferes with their operations, reducing the amount of natural gas they can recover. SJCC compensated certain gas producers for any remaining production from wells deemed close enough to the mine to warrant plugging and abandoning them. These settlements, however, do not resolve all potential claims by gas producers in the area. TEP owns 50% of Units 1 and 2 at San Juan Generating Station (San Juan), which represents approximately 20% of the total generation capacity at San Juan, and is responsible for its share of any settlements. TEP cannot estimate the impact of any future claims by these gas producers on the cost of coal at San Juan.

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

**Claims Related to Four Corners Generating Station**

In October 2011, EarthJustice, on behalf of several environmental organizations, filed a lawsuit in the United States District Court for the District of New Mexico against Arizona Public Service Company (APS) and the other Four Corners Generating Station (Four Corners) participants alleging violations of the Prevention of Significant Deterioration (PSD) provisions of the Clean Air Act at Four Corners. In January 2012, EarthJustice amended their complaint alleging violations of New Source Performance Standards resulting from equipment replacements at Four Corners. Among other things, the plaintiffs seek to have the court issue an order to cease operations at Four Corners until any required PSD permits are issued and order the payment of civil penalties, including a beneficial mitigation project. In April 2012, APS filed motions to dismiss with the court for all claims asserted by EarthJustice in the amended complaint. The joint participants have agreed to have the matter stayed until August 2014 in furtherance of settlement talks.

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

In May 2013, the New Mexico Taxation and Revenue Department issued a notice of assessment for coal severance tax, penalties, and interest totaling $30 million to the coal supplier at Four Corners. In December 2013, the coal supplier and Four

Corners' operating agent filed a claim contesting the validity of the assessment on behalf of the participants in Four Corners, who will be liable for their share of any resulting liabilities. TEP's share of the assessment based on its ownership of Four Corners is approximately $1 million. The New Mexico Taxation and Revenue Department and APS started settlement negotiations in July 2014. TEP cannot predict the outcome or timing of resolution of this claim.

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

TEP pays ongoing reclamation costs related to coal mines that supply generating stations in which TEP has an ownership interest but does not operate. TEP is liable for a portion of final reclamation costs upon closure of the mines servicing Navajo, San Juan, and Four Corners. TEP's share of reclamation costs at all three mines is expected to be $44 million upon expiration of the coal supply agreements, which expire between 2017 and 2031. The reclamation liability (present value of future liability) recorded was $20 million at June 30, 2014 and $18 million at December 31, 2013.

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

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

**Discontinued Transmission Project**

TEP and UNS Electric had initiated a project to jointly construct a 60-mile transmission line from Tucson, Arizona to Nogales, Arizona in response to an order by the ACC to UNS Electric to improve the reliability of electric service in Nogales. TEP and UNS Electric will not proceed with the project based on the cost of the proposed 345-kV line, the difficulty in reaching agreement with the United States Forest Service on a path for the line, and concurrence by the ACC of recent transmission plans filed by TEP and UNS Electric supporting elimination of this project. TEP and UNS Electric plan to keep the path approved in the line siting matter in contemplation of using a greater part of the route to serve future customers and to address reliability needs. As part of the 2013 TEP Rate Order, TEP agreed to seek recovery of the project costs from FERC before seeking rate recovery from the ACC. In 2012, TEP wrote off $5 million of the capitalized costs believed not probable of recovery and recorded a regulatory asset of $5 million for the balance deemed probable of recovery.

**Performance Guarantees**

The participants in each of the remote generating stations in which TEP participates, including TEP, have guaranteed certain performance obligations of the other participants. Specifically, in the event of payment default of a participant, the non-defaulting participants have agreed to bear a proportionate share of expenses otherwise payable by the defaulting participant. In exchange, the non-defaulting participants are entitled to receive their proportionate share of the generating capacity of the defaulting participants. As of June 30, 2014, there have been no such payment defaults under any of the remote generating station agreements. TEP's joint participation agreements expire in 2016 through 2046.

**UNS ELECTRIC CONTINGENCIES**

**Planned Purchase of Gas-Fired Generation Facility**

In 2013, TEP and UNS Electric entered into an agreement to purchase a gas-fired generation facility. See Note 7.

**ENVIRONMENTAL MATTERS**

**Environmental Regulation**

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

**Hazardous Air Pollutant Requirements**

In February 2012, the EPA issued final rules for the control of mercury emissions and other hazardous air pollutants from power plants. Based on the EPA's final Mercury and Air Toxics (MATS) rules, additional emission control equipment will be required by April 2015. TEP has received an extension until April 2016 to comply with the MATS rules at Springerville. The operator of Navajo has also received an extension until April 2016. TEP's share of the estimated costs to comply with the MATS rules include the following:

| Estimated Mercury Emissions Control Costs: | Navajo | Four Corners | Springerville[(1)] |
|---|---|---|---|
| | | Millions of Dollars | |
| Capital Expenditures | $ 1 | $ 1 | $ 5 |
| Annual O&M Expenses | 1 | 1 | 1 |

(1) Total capital expenditures and annual O&M expenses represent amounts for both Springerville Units 1 & 2, with estimated costs split equally between the two units. TEP will own 49.5% of Springerville Unit 1 upon close of the lease option purchases in January 2015; after the completion of such purchases, third party owners will be responsible for 50.5% of environmental costs attributable to Springerville Unit 1. TEP will continue to be responsible for 100% of environmental costs attributable to Springerville Unit 2.

TEP expects Sundt and San Juan's current emission controls to be adequate to comply with the EPA's MATS rules.

**Regional Haze Rules**

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

In the western U.S., Regional Haze BART determinations have focused on controls for NOx, often resulting in a requirement to install selective catalytic reduction (SCR). Complying with the EPA's BART rules, and with other future environmental rules, may make it economically impractical to continue operating the Navajo, San Juan, and Four Corners power plants or for individual owners to continue to participate in these power plants. BART provisions of Regional Haze Rules requiring emission control upgrades do not apply to Springerville because the BART rules apply to plants built prior to Springerville. TEP cannot predict the ultimate outcome of these matters.

TEP's estimated costs involved in meeting these rules are:

| Estimated NOx Emissions Control Costs: | Navajo[(1)] | San Juan[(2)] | Four Corners[(3)] | Sundt[(4)] |
|---|---|---|---|---|
| | | Millions of Dollars | | |
| Capital Expenditures | $ 42 | $ 35 | $ 35 | $ 12 |
| Annual O&M Expenses | 1 | 1 | 2 | 5-6 |

(1) The EPA is considering a better-than-BART plan wherein: one unit at Navajo will be shut down by 2020; SCR (or the equivalent) will be installed on the remaining two units by 2030; and conventional coal-fired generation will cease by December 2044. TEP expects the EPA to reach a decision in 2014. In addition, the installation of SCR technology could increase particulates which may require that baghouses be installed. TEP owns 7.5% of Navajo. TEP's share of the capital cost of baghouses in addition to the SCR costs reflected in the table above is approximately $43 million with O&M on the baghouses expected to be less than $1 million per year.

(2) The Federal Implementation Plan (FIP) for San Juan requires SCRs for which TEP estimates its share of capital costs will be $180-$200 million with annual O&M of $6 million. As part of a proposal for an alternative, Public Service Company of New Mexico (PNM), the State of New Mexico, and the EPA signed a non-binding agreement in which PNM agreed to close Units 2 and 3 by December 2017 and install selective non-catalytic reduction (SNCR) on Units 1 and 4 by January 2016 or later depending on the timing of EPA approvals. Estimated costs for SNCR are reflected in the table above. The State of New Mexico has submitted this plan to the EPA and the EPA has proposed to approve the alternative state plan which would replace the existing FIP. TEP expects the EPA will reach a final decision in 2014. TEP owns 50% of San Juan Unit 2. At June 30, 2014, the net book value of TEP's share in San Juan Unit 2 was $112 million. If Unit 2 is retired early, TEP expects to request ACC approval to recover, over a reasonable time period, all costs associated with the early closure of the unit.

(3) In December 2013, APS, on behalf of the co-owners of Four Corners, notified the EPA that they have chosen an alternative BART compliance strategy; as a result, APS closed Units 1, 2, and 3 in December 2013 and has agreed to the installation of SCR on Units 4 & 5 by July 2018. TEP owns 7% of Four Corners Units 4 and 5.

(4) In June 2014, the EPA issued a final rule that would require TEP to either (i) install SNCR and dry sorbent injection technology on Unit 4 by mid-2017 or (ii) eliminate the use of coal by the end of 2017 as a better-than-BART alternative. TEP is required to notify the EPA of its decision by March 2017. At June 30, 2014, the net book value of the Sundt coal handling facilities was $27 million. If the coal handling facilities are retired early, TEP expects to request ACC approval to recover, over a reasonable time period, all the remaining costs of the coal handling facilities.

## NOTE 7. PLANNED PURCHASE OF GAS-FIRED GENERATION FACILITY

In December 2013, TEP and UNS Electric entered into a purchase agreement with a subsidiary of Entegra to purchase Gila River Unit 3 for $219 million, subject to certain closing adjustments. Gila River Unit 3, a gas-fired combined cycle unit with a nominal capacity rating of 550 MW, is located in Gila Bend, Arizona. TEP expects to purchase a 75% undivided interest in Gila River Unit 3 (413 MW) for approximately $164 million, and UNS Electric expects to purchase the remaining 25% undivided interest (137 MW) for approximately $55 million. TEP and UNS Electric expect the transaction to close in December 2014, subject to FERC approval and other closing conditions.

In December 2013, UNS Electric filed an application for an accounting order with the ACC requesting authorization for UNS Electric to defer for future recovery specific non-fuel operating costs associated with Gila River Unit 3. The application is still pending before the ACC.

In June 2014, TEP provided a letter of credit (LOC) for $15 million to the seller of Gila River Unit 3 to satisfy a condition of the purchase agreement. The seller is entitled to draw upon the LOC and apply such amount as liquidated damages if it has validly terminated the purchase agreement as a result of misrepresentations by TEP and UNS Electric or the failure of TEP and UNS Electric to close the transaction when the closing conditions have been satisfied. Upon the close of the transaction, the LOC will be canceled.

## NOTE 8. EMPLOYEE BENEFIT PLANS

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

| | Pension Benefits | | Other Retiree Benefits | |
|---|---|---|---|---|
| | Three Months Ended June 30, | | | |
| | 2014 | 2013 | 2014 | 2013 |
| | Millions of Dollars | | | |
| Service Cost | $ 2 | $ 3 | $ 1 | $ 1 |
| Interest Cost | 5 | 4 | — | 1 |
| Expected Return on Plan Assets | (5) | (5) | — | — |
| Actuarial Loss Amortization | 1 | 2 | — | — |
| **Net Periodic Benefit Cost** | $ 3 | $ 4 | $ 1 | $ 2 |

| | Pension Benefits | | Other Retiree Benefits | |
|---|---|---|---|---|
| | Six Months Ended June 30, | | | |
| | 2014 | 2013 | 2014 | 2013 |
| | Millions of Dollars | | | |
| Service Cost | $ 5 | $ 6 | $ 2 | $ 2 |
| Interest Cost | 9 | 8 | 1 | 1 |
| Expected Return on Plan Assets | (11) | (10) | — | — |
| Actuarial Loss Amortization | 2 | 4 | — | — |
| **Net Periodic Benefit Cost** | $ 5 | $ 8 | $ 3 | $ 3 |

## NOTE 9. SHARE-BASED COMPENSATION PLANS

### RESTRICTED STOCK UNITS

In May 2014, the UNS Energy Compensation Committee (Compensation Committee) granted 7,486 restricted stock units to non-employee directors at a grant date fair value, based on the grant date closing share price, of $60.11 per share. We recognize compensation expense equal to the fair value on the grant date over the one-year vesting period. We issue UNS Energy Common Stock (Common Stock) for the vested restricted stock units at the time elected by each of the non-employee directors based on certain eligibility requirements. These restricted stock units accrue dividend equivalents during and subsequent to the vesting period, which are distributed in shares of Common Stock at the same time as the related restricted stock units.

In February 2014, the Compensation Committee granted 16,910 restricted stock units to certain management employees at a grant date fair value, based on the grant date closing share price, of $60.39 per share. The restricted stock units vest on the third anniversary of grant and are distributed in shares of Common Stock upon vesting. We recognize compensation expense equal to the fair value on the grant date over the vesting period. These restricted stock units accrue dividend equivalents during the vesting period, which are distributed in shares of Common Stock upon vesting.

### PERFORMANCE SHARES

In February 2014, the Compensation Committee granted 33,820 performance share awards to certain management employees. Half of the performance share awards had a grant date fair value, based on a Monte Carlo simulation, of $57.47 per share. Those awards will be paid out in Common Stock based on UNS Energy's compound annualized total shareholder return relative to the companies included in the Edison Electric Institute Utility Index for the three-year performance period ended December 31, 2016. We recognize compensation expense equal to the fair value on the grant date over the vesting period if the requisite service period is fulfilled, whether or not the threshold is achieved. The remaining half had a grant date fair value, based on the grant date closing share price, of $60.39 per share and will be paid out in Common Stock based on cumulative net income for the three-year performance period ended December 31, 2016. We recognize compensation expense equal to the fair value on the grant date over the requisite service period only for the awards that ultimately vest.

The performance shares vest based on the achievement of these goals by the end of the three-year performance period; any unearned awards are forfeited. Performance shares accrue dividend equivalents during the performance period, which are paid upon vesting.

### SHARE-BASED COMPENSATION EXPENSE

UNS Energy and TEP recorded share-based compensation expense of less than $1 million for the three months ended June 30, 2014 and June 30, 2013. For the six months ended June 30, 2014, UNS Energy recorded share-based compensation expense of $2 million, $1 million of which related to TEP. For the six months ended June 30, 2013, UNS Energy and TEP recorded share-based compensation expense of $1 million.

At June 30, 2014, the total unrecognized compensation cost related to non-vested share-based compensation was $5 million, of which $4 million are allocable to TEP, which will be recorded as compensation expense over the remaining vesting periods through February 2017. The completion of the Merger would result in accelerated vesting and expense recognition for these awards. See Note 2. At June 30, 2014, less than 0.5 million shares were awarded but not yet issued, including target performance shares, under the share-based compensation plans.

## NOTE 10. UNS ENERGY EARNINGS PER SHARE

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | Thousands of Dollars | | | |
| **Numerator: Net Income** | $ 42,354 | $ 34,618 | $ 57,829 | $ 45,963 |
| | Thousands of Shares | | | |
| **Denominator:** | | | | |
| Weighted Average Shares of Common Stock Outstanding: | | | | |
| Common Shares Issued | 41,659 | 41,427 | 41,639 | 41,404 |
| Fully Vested Deferred Stock Units | 122 | 171 | 120 | 165 |
| **Total Weighted Average Common Stock Outstanding — Basic** | 41,781 | 41,598 | 41,759 | 41,569 |
| Effect of Dilutive Securities: | | | | |
| Options and Stock Issuable Under Share-Based Compensation Plans | 364 | 323 | 356 | 329 |
| **Total Weighted Average Common Stock Outstanding — Diluted** | 42,145 | 41,921 | 42,115 | 41,898 |

For the six months ended June 30, 2013, we excluded 12,000 contingently issuable shares from our diluted EPS computation as their effect would be anti-dilutive.

## NOTE 11. SUPPLEMENTAL CASH FLOW INFORMATION

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

| | UNS Energy | |
|---|---|---|
| | Six Months Ended June 30, | |
| | 2014 | 2013 |
| | Thousands of Dollars | |
| **Net Income** | $ 57,829 | $ 45,963 |
| **Adjustments to Reconcile Net Income** | | |
| **To Net Cash Flows from Operating Activities** | | |
| Depreciation Expense | 78,644 | 72,970 |
| Amortization Expense | 12,631 | 16,408 |
| Depreciation and Amortization Recorded to Fuel and O&M Expense | 3,977 | 3,516 |
| Amortization of Deferred Debt-Related Costs included in Interest Expense | 1,584 | 1,515 |
| Provision for Retail Customer Bad Debts | 1,194 | 936 |
| Use of Renewable Energy Credits for Compliance | 11,313 | 8,106 |
| Deferred Income Taxes | 36,320 | 36,644 |
| Investment Tax Credit Basis Adjustment - Creation of Regulatory Asset | — | (11,039) |
| Pension and Retiree Expense | 7,884 | 11,391 |
| Pension and Retiree Funding | (5,974) | (8,924) |
| Share-Based Compensation Expense | 1,859 | 1,390 |
| Allowance for Equity Funds Used During Construction | (4,038) | (2,463) |
| LFCR Revenue | (7,654) | — |
| Decrease to Reflect PPFAC/PGA Recovery | (21,437) | (3,294) |
| PPFAC Reduction - 2013 TEP Rate Order | — | 3,000 |
| Changes in Assets and Liabilities which Provided (Used) | | |
| Cash Exclusive of Changes Shown Separately | | |
| Accounts Receivable | (22,766) | (20,706) |
| Materials and Fuel Inventory | (4,413) | 8,777 |
| Accounts Payable | (5,875) | (9,576) |
| Income Taxes | (88) | (15,980) |
| Interest Accrued | 1,305 | (6,885) |
| Taxes Other Than Income Taxes | 3,721 | 490 |
| Other | (8,259) | 15,413 |
| **Net Cash Flows – Operating Activities** | $ 137,757 | $ 147,652 |

| | TEP | |
|---|---|---|
| | Six Months Ended June 30, | |
| | 2014 | 2013 |
| | Thousands of Dollars | |
| **Net Income** | $ 47,897 | $ 32,266 |
| **Adjustments to Reconcile Net Income** | | |
| **To Net Cash Flows from Operating Activities** | | |
| Depreciation Expense | 61,891 | 57,418 |
| Amortization Expense | 14,476 | 18,275 |
| Depreciation and Amortization Recorded to Fuel and O&M Expense | 3,406 | 2,987 |
| Amortization of Deferred Debt-Related Costs Included in Interest Expense | 1,285 | 1,216 |
| Provision for Retail Customer Bad Debts | 833 | 711 |
| Use of Renewable Energy Credits for Compliance | 9,884 | 7,414 |
| Deferred Income Taxes | 29,641 | 24,883 |
| Investment Tax Credit Basis Adjustment - Creation of Regulatory Asset | — | (10,751) |
| Pension and Retiree Expense | 6,824 | 9,939 |
| Pension and Retiree Funding | (5,522) | (8,493) |
| Share-Based Compensation Expense | 1,496 | 1,108 |
| Allowance for Equity Funds Used During Construction | (3,524) | (1,763) |
| LFCR Revenue | (6,121) | — |
| Increase (Decrease) to Reflect PPFAC Recovery | (14,791) | 2,914 |
| PPFAC Reduction - 2013 TEP Rate Order | — | 3,000 |
| Changes in Assets and Liabilities which Provided (Used) | | |
| Cash Exclusive of Changes Shown Separately | | |
| Accounts Receivable | (35,498) | (30,452) |
| Materials and Fuel Inventory | (3,936) | 8,923 |
| Accounts Payable | 6,019 | (11) |
| Income Taxes | (6) | (10,798) |
| Interest Accrued | 1,320 | (6,886) |
| Taxes Other Than Income Taxes | 5,247 | 2,295 |
| Other | (7,779) | 11,347 |
| **Net Cash Flows – Operating Activities** | $ 113,042 | $ 115,542 |

**NON-CASH TRANSACTIONS**

In April 2014, TEP recorded an increase of $109 million to both Utility Plant Under Capital Leases and Current Obligations Under Capital Leases due to TEP's commitment to purchase lease interests in April 2015. See Note 5.

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

## NOTE 12. FAIR VALUE MEASUREMENTS AND DERIVATIVE INSTRUMENTS

We categorize our assets and liabilities accounted for at fair value into the three-level hierarchy based on inputs used to determine the fair value. Level 1 inputs are unadjusted quoted prices for identical assets or liabilities in an active market. Level 2 inputs include quoted prices for similar assets or liabilities, quoted prices in non-active markets, and pricing models whose inputs are observable, directly or indirectly. Level 3 inputs are unobservable and supported by little or no market activity. Transfers between levels are recorded at the end of a reporting period. There were no transfers between levels in the periods presented.

## FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A RECURRING BASIS

The following tables present, by level within the fair value hierarchy, UNS Energy's and TEP's assets and liabilities accounted for at fair value on a recurring basis. These assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| | UNS Energy | | | | | |
|---|---|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 | Counterparty Netting of Energy Contracts Not Offset on the Balance Sheets[5] | Net Amount |
| | June 30, 2014 | | | | | |
| | Millions of Dollars | | | | | |
| **Assets** | | | | | | |
| Cash Equivalents[1] | $ 13 | $ 13 | $ — | $ — | $ — | $ 13 |
| Restricted Cash[1] | 2 | 2 | — | — | — | 2 |
| Rabbi Trust Investments[2] | 23 | — | 23 | — | — | 23 |
| Energy Contracts - Regulatory Recovery[3] | 11 | — | 5 | 6 | (3) | 8 |
| **Total Assets** | 49 | 15 | 28 | 6 | (3) | 46 |
| **Liabilities** | | | | | | |
| Energy Contracts - Regulatory Recovery[3] | (5) | — | (1) | (4) | 3 | (2) |
| Energy Contracts - Cash Flow Hedge[3] | (1) | — | — | (1) | — | (1) |
| Interest Rate Swaps[4] | (6) | — | (6) | — | — | (6) |
| **Total Liabilities** | (12) | — | (7) | (5) | 3 | (9) |
| **Net Total Assets (Liabilities)** | $ 37 | $ 15 | $ 21 | $ 1 | $ — | $ 37 |

| | UNS Energy | | | | | |
|---|---|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 | Counterparty Netting of Energy Contracts Not Offset on the Balance Sheets[5] | Net Amount |
| | December 31, 2013 | | | | | |
| | Millions of Dollars | | | | | |
| **Assets** | | | | | | |
| Cash Equivalents[1] | $ 14 | $ 14 | $ — | $ — | $ — | $ 14 |
| Restricted Cash[1] | 2 | 2 | — | — | — | 2 |
| Rabbi Trust Investments[2] | 22 | — | 22 | — | — | 22 |
| Energy Contracts - Regulatory Recovery[3] | 7 | — | 3 | 4 | (5) | 2 |
| **Total Assets** | 45 | 16 | 25 | 4 | (5) | 40 |
| **Liabilities** | | | | | | |
| Energy Contracts - Regulatory Recovery[3] | (7) | — | (2) | (5) | 5 | (2) |
| Energy Contracts - Cash Flow Hedge[3] | (1) | — | — | (1) | — | (1) |
| Interest Rate Swaps[4] | (7) | — | (7) | — | — | (7) |
| **Total Liabilities** | (15) | — | (9) | (6) | 5 | (10) |
| **Net Total Assets (Liabilities)** | $ 30 | $ 16 | $ 16 | $ (2) | $ — | $ 30 |

| | TEP | | | | | |
|---|---|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 | Counterparty Netting of Energy Contracts Not Offset on the Balance Sheets[5] | Net Amount |
| | June 30, 2014 | | | | | |
| | Millions of Dollars | | | | | |
| **Assets** | | | | | | |
| Cash Equivalents[1] | $ — | $ — | $ — | $ — | $ — | $ — |
| Restricted Cash[1] | 2 | 2 | — | — | — | 2 |
| Rabbi Trust Investments[2] | 23 | — | 23 | — | — | 23 |
| Energy Contracts - Regulatory Recovery[3] | 5 | — | 2 | 3 | (2) | 3 |
| **Total Assets** | 30 | 2 | 25 | 3 | (2) | 28 |
| **Liabilities** | | | | | | |
| Energy Contracts - Regulatory Recovery[3] | (3) | — | (1) | (2) | 2 | (1) |
| Energy Contracts - Cash Flow Hedge[3] | (1) | — | — | (1) | — | (1) |
| Interest Rate Swaps[4] | (6) | — | (6) | — | — | (6) |
| **Total Liabilities** | (10) | — | (7) | (3) | 2 | (8) |
| **Net Total Assets (Liabilities)** | $ 20 | $ 2 | $ 18 | $ — | $ — | $ 20 |

| | TEP | | | | | |
|---|---|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 | Counterparty Netting of Energy Contracts Not Offset on the Balance Sheets[5] | Net Amount |
| | December 31, 2013 | | | | | |
| | Millions of Dollars | | | | | |
| **Assets** | | | | | | |
| Cash Equivalents[1] | $ — | $ — | $ — | $ — | $ — | $ — |
| Restricted Cash[1] | 2 | 2 | — | — | — | 2 |
| Rabbi Trust Investments[2] | 22 | — | 22 | — | — | 22 |
| Energy Contracts - Regulatory Recovery[3] | 2 | — | 1 | 1 | (1) | 1 |
| **Total Assets** | 26 | 2 | 23 | 1 | (1) | 25 |
| **Liabilities** | | | | | | |
| Energy Contracts - Regulatory Recovery[3] | (2) | — | — | (2) | 1 | (1) |
| Energy Contracts - Cash Flow Hedge[3] | (1) | — | — | (1) | — | (1) |
| Interest Rate Swaps[4] | (7) | — | (7) | — | — | (7) |
| **Total Liabilities** | (10) | — | (7) | (3) | 1 | (9) |
| **Net Total Assets (Liabilities)** | $ 16 | $ 2 | $ 16 | $ (2) | $ — | $ 16 |

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

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

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

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

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

## DERIVATIVE INSTRUMENTS

We enter into various derivative and non-derivative contracts to reduce our exposure to energy price risk associated with our gas and purchased power requirements. The objectives for entering into such contracts include: creating price stability; meeting load and reserve requirements; and reducing exposure to price volatility that may result from delayed recovery under the PPFAC or PGA.

We primarily apply the market approach for recurring fair value measurements. When we have observable inputs for substantially the full term of the asset or liability or use quoted prices in an inactive market, we categorize the instrument in Level 2. We categorize derivatives in Level 3 when we use an aggregate pricing service or published prices that represent a consensus reporting of multiple brokers.

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

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

We estimate the fair value of our gas options using a Black-Scholes-Merton option pricing model which includes inputs such as implied volatility, interest rates, and forward price curves. In the first half of 2013, we also used this pricing model to value our power options.

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

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

### Cash Flow Hedges

We enter into interest rate swaps to mitigate the exposure to volatility in variable interest rates on debt. The interest rate swap agreements expire through January 2020. We also have a power purchase swap to hedge the cash flow risk associated with a long-term power supply agreement. The power purchase swap agreement expires in September 2015. The after-tax unrealized gains and losses on cash flow hedge activities and amounts reclassified to earnings are reported in the statements of other comprehensive income and Note 14. The loss expected to be reclassified to earnings within the next twelve months is estimated to be $3 million for UNS Energy and TEP.

### Financial Impact of Energy Contracts

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

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | Three Months Ended June 30, | | | |
| | 2014 | 2013 | 2014 | 2013 |
| | Millions of Dollars | | | |
| Unrealized Net Gain (Loss) Recorded to Regulatory Assets/Liabilities | $ 1 | $ (9) | $ 2 | $ (3) |

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | Six Months Ended June 30, | | | |
| | 2014 | 2013 | 2014 | 2013 |
| | Millions of Dollars | | | |
| Unrealized Net Gain (Loss) Recorded to Regulatory Assets/Liabilities | $ 5 | $ — | $ 2 | $ (1) |

Realized gains and losses on settled contracts are fully recoverable through the PPFAC or PGA. At June 30, 2014, UNS Energy and TEP have energy contracts that will settle through the second quarter of 2017.

**Derivative Volumes**

The volumes associated with our energy contracts were as follows:

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | June 30, 2014 | December 31, 2013 | June 30, 2014 | December 31, 2013 |
| Power Contracts GWh | 1,933 | 1,583 | 976 | 779 |
| Gas Contracts GBtu | 63,546 | 33,371 | 27,176 | 9,615 |

**Level 3 Fair Value Measurements**

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

| | Valuation Approach | Fair Value at June 30, 2014 Assets | Liabilities | Unobservable Inputs | Range of Unobservable Input |
|---|---|---|---|---|---|
| | | Millions of Dollars | | | |
| **Forward Contracts[1]** | Market approach | $ 4 | $ (4) | Market price per MWh | $ 23.90 - $ 57.90 |
| **Option Contracts[2]** | Option model | 2 | (1) | Market price per MMbtu | $ 3.87 - $ 4.57 |
| | | | | Gas volatility | 21.01 % - 32.10 % |
| **Level 3 Energy Contracts** | | $ 6 | $ (5) | | |

| | Valuation Approach | Fair Value at December 31, 2013 Assets | Liabilities | Unobservable Inputs | Range of Unobservable Input |
|---|---|---|---|---|---|
| | | Millions of Dollars | | | |
| **Forward Contracts[3]** | Market approach | $ 1 | $ (4) | Market price per MWh | $ 26.54 - $ 51.75 |
| **Option Contracts[4]** | Option model | 3 | (2) | Market price per MMbtu | $ 3.87 - $ 4.32 |
| | | | | Gas volatility | 25.05 % - 35.07 % |
| **Level 3 Energy Contracts** | | $ 4 | $ (6) | | |

(1) TEP comprises $2 million of the forward contract assets and $2 million of the forward contract liabilities at June 30, 2014.

(2) TEP comprises $1 million of the option contract assets and $1 million of the option contract liabilities at June 30, 2014.

(3) TEP comprises $1 million of the forward contract assets and $3 million of the forward contract liabilities at December 31, 2013.

(4) TEP comprises less than $1 million of the option contract assets at December 31, 2013.

Changes in one or more of the unobservable inputs could have a significant impact on the fair value measurement depending on the magnitude of the change and the direction of the change for each input. The impact of changes to fair value, including changes from unobservable inputs, are subject to recovery or refund through the PPFAC or PGA mechanisms and are reported as a regulatory asset or regulatory liability, or as a component of other comprehensive income, rather than in the income statement.

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

| | UNS Energy | TEP |
|---|---|---|
| | Three Months Ended June 30, 2014 | |
| | Millions of Dollars | |
| **Balances at March 31, 2014** | $ — | $ (2) |
| Realized/Unrealized Gains/(Losses) Recorded to: | | |
| Net Regulatory Assets/Liabilities – Derivative Instruments | 3 | 2 |
| Settlements | (2) | — |
| **Balances at June 30, 2014** | $ 1 | $ — |
| Total Gains/(Losses) Attributable to the Change in Unrealized Gains/(Losses) Relating to Assets/Liabilities Still Held at the End of the Period | $ 3 | $ 3 |

| | UNS Energy | TEP |
|---|---|---|
| | Six Months Ended June 30, 2014 | |
| | Millions of Dollars | |
| **Balances at December 31, 2013** | $ (2) | $ (2) |
| Realized/Unrealized Gains/(Losses) Recorded to: | | |
| Net Regulatory Assets/Liabilities – Derivative Instruments | 5 | 1 |
| Settlements | (2) | 1 |
| **Balances at June 30, 2014** | $ 1 | $ — |
| Total Gains/(Losses) Attributable to the Change in Unrealized Gains/(Losses) Relating to Assets/Liabilities Still Held at the End of the Period | $ 2 | $ 1 |

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

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

## 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 non-performance by counterparties pursuant to the terms of their contractual obligations. We 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 subsequent measurement at fair value.

We have contractual agreements for energy procurement and hedging activities that contain certain provisions requiring each company to post collateral under certain circumstances. These circumstances include: exposures in excess of unsecured credit limits provided to the Regulated Utilities; credit rating downgrades; or a failure to meet certain financial ratios. In the event that such credit events were to occur, we would have to provide certain credit enhancements in the form of cash or LOCs to fully collateralize our exposure to these counterparties.

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.

Material adverse changes could trigger credit risk-related contingent features. At June 30, 2014, the value of derivative instruments in a net liability position under contracts with credit risk-related contingent features, including contracts under the normal purchase normal sale exception, was $25 million for UNS Energy and $19 million for TEP. The additional collateral to be posted if credit-risk contingent features were triggered would be $25 million for UNS Energy and $19 million for TEP.

## FINANCIAL INSTRUMENTS NOT CARRIED AT FAIR VALUE

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

- The carrying amounts of our current maturities of long-term debt and amounts outstanding under our credit agreements approximate the fair values due to the short-term nature of these financial instruments. These items have been excluded from the table below.
- For Investment in Lease Equity, we estimate the price at which an investor would realize a target internal rate of return. Our estimates include: the mix of debt and equity an investor would use to finance the purchase; the cost of debt; the required return on equity; and income tax rates. The estimate assumes a residual value based on an appraisal of Springerville Unit 1 conducted in 2011.
- For Long-Term Debt, we use quoted market prices, when available, or calculate the present value of remaining cash flows at the balance sheet date. When calculating present value, we use current market rates for bonds with similar characteristics such as credit rating and time-to-maturity. We consider the principal amounts of variable rate debt outstanding to be reasonable estimates of the fair value. We also incorporate the impact of our own credit risk using a credit default swap rate.

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

| | | June 30, 2014 | | December 31, 2013 | |
|---|---|---|---|---|---|
| | Fair Value Hierarchy | Carrying Value | Fair Value | Carrying Value | Fair Value |
| | | Millions of Dollars | | | |
| **Assets:** | | | | | |
| TEP Investment in Lease Equity | Level 3 | $ 36 | $ 25 | $ 36 | $ 25 |
| **Liabilities:** | | | | | |
| Long-Term Debt | | | | | |
| UNS Energy | Level 2 | $ 1,677 | $ 1,771 | $ 1,507 | $ 1,521 |
| TEP | Level 2 | 1,372 | 1,435 | 1,223 | 1,214 |

## NOTE 13. INCOME TAXES

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

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | Three Months Ended June 30, | | | |
| | 2014 | 2013 | 2014 | 2013 |
| | Millions of Dollars | | | |
| **Federal Income Tax Expense at Statutory Rate** | $ 24 | $ 14 | $ 22 | $ 12 |
| State Income Tax Expense, Net of Federal Deduction | 3 | 2 | 3 | 2 |
| Federal/State Tax Credits | (2) | — | (2) | — |
| Investment Tax Credit Basis Adjustment - Creation of Regulatory Asset | — | (11) | — | (11) |
| Other | — | (1) | — | (1) |
| **Total Federal and State Income Tax Expense** | $ 25 | $ 4 | $ 23 | $ 2 |

| | UNS Energy | | TEP | |
|---|---|---|---|---|
| | Six Months Ended June 30, | | | |
| | 2014 | 2013 | 2014 | 2013 |
| | Millions of Dollars | | | |
| **Federal Income Tax Expense at Statutory Rate** | $ 32 | $ 20 | $ 27 | $ 12 |
| State Income Tax Expense, Net of Federal Deduction | 4 | 3 | 3 | 2 |
| Federal/State Tax Credits | (2) | — | (2) | — |
| Investment Tax Credit Basis Adjustment - Creation of Regulatory Asset | — | (11) | — | (11) |
| Other | 1 | (1) | — | — |
| **Total Federal and State Income Tax Expense** | $ 35 | $ 11 | $ 28 | $ 3 |

**Investment Tax Credit Basis Adjustment - Creation of Regulatory Asset**

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

## NOTE 14. RECLASSIFICATIONS FROM ACCUMULATED OTHER COMPREHENSIVE INCOME BY COMPONENT

The reclassifications from Accumulated Other Comprehensive Income (AOCI) by component are as follows:

**UNS Energy**

| Details About Accumulated Other Comprehensive Income Components | Amount Reclassified from Other Comprehensive Income | | Affected Line Item in the Income Statement |
|---|---|---|---|
| | Three Months Ended June 30, | | |
| | 2014 | 2013 | |
| | Thousands of Dollars | | |
| Realized Losses on Cash Flow Hedges | | | |
| Interest Rate Swaps - Debt | $ (349) | $ (346) | Interest Expense Long-Term Debt |
| Interest Rate Swaps - Capital Leases | (602) | (604) | Interest Expense Capital Leases |
| Commodity Contracts | (143) | (191) | Purchased Energy/Purchased Power |
| Tax Benefit | 430 | 451 | |
| Realized Losses on Cash Flow Hedges, Net of Taxes | (664) | (690) | |
| Amortization of SERP | | | |
| Prior Service Cost and Net Loss | (40) | (111) | Operations and Maintenance |
| Tax Benefit | 15 | 43 | |
| Amortization, Net of Taxes | (25) | (68) | |
| Total Reclassifications from Other Comprehensive Income for the Period | $ (689) | $ (758) | |

**UNS Energy**

| Details About Accumulated Other Comprehensive Income Components | Amount Reclassified from Other Comprehensive Income | | Affected Line Item in the Income Statement |
|---|---|---|---|
| | Six Months Ended June 30, | | |
| | 2014 | 2013 | |
| | Thousands of Dollars | | |
| Realized Losses on Cash Flow Hedges | | | |
| Interest Rate Swaps - Debt | $ (702) | $ (676) | Interest Expense Long-Term Debt |
| Interest Rate Swaps - Capital Leases | (1,198) | (1,208) | Interest Expense Capital Leases |
| Commodity Contracts | (143) | (191) | Purchased Energy/Purchased Power |
| Tax Benefit | 734 | 820 | |
| Realized Losses on Cash Flow Hedges, Net of Taxes | (1,309) | (1,255) | |
| Amortization of SERP | | | |
| Prior Service Cost and Net Loss | (79) | (222) | Operations and Maintenance |
| Tax Benefit | 30 | 85 | |
| Amortization, Net of Taxes | (49) | (137) | |
| Total Reclassifications from Other Comprehensive Income for the Period | $ (1,358) | $ (1,392) | |

TEP

| Details About Accumulated Other Comprehensive Income Components | Amount Reclassified from Other Comprehensive Income | | Affected Line Item in the Income Statement |
|---|---|---|---|
| | Three Months Ended June 30, | | |
| | 2014 | 2013 | |
| | Thousands of Dollars | | |
| Realized Losses on Cash Flow Hedges | | | |
| Interest Rate Swaps - Debt | $ (293) | $ (293) | Interest Expense Long-Term Debt |
| Interest Rate Swaps - Capital Leases | (602) | (604) | Interest Expense Capital Leases |
| Commodity Contracts | (143) | (191) | Purchased Energy/Purchased Power |
| Tax Benefit | 408 | 429 | |
| Realized Losses on Cash Flow Hedges, Net of Taxes | (630) | (659) | |
| Amortization of SERP | | | |
| Prior Service Cost and Net Loss | (40) | (111) | Other Expense |
| Tax Benefit | 15 | 43 | |
| Amortization, Net of Taxes | (25) | (68) | |
| Total Reclassifications from Other Comprehensive Income for the Period | $ (655) | $ (727) | |

TEP

| Details About Accumulated Other Comprehensive Income Components | Amount Reclassified from Other Comprehensive Income | | Affected Line Item in the Income Statement |
|---|---|---|---|
| | Six Months Ended June 30, | | |
| | 2014 | 2013 | |
| | Thousands of Dollars | | |
| Realized Losses on Cash Flow Hedges | | | |
| Interest Rate Swaps - Debt | $ (591) | $ (575) | Interest Expense Long-Term Debt |
| Interest Rate Swaps - Capital Leases | (1,198) | (1,208) | Interest Expense Capital Leases |
| Commodity Contracts | (143) | (191) | Purchased Energy/Purchased Power |
| Tax Benefit | 692 | 781 | |
| Realized Losses on Cash Flow Hedges, Net of Taxes | (1,240) | (1,193) | |
| Amortization of SERP | | | |
| Prior Service Cost and Net Loss | (79) | (222) | Other Expense |
| Tax Benefit | 30 | 85 | |
| Amortization, Net of Taxes | (49) | (137) | |
| Total Reclassifications from Other Comprehensive Income for the Period | $ (1,289) | $ (1,330) | |

**NOTE 15. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

In April 2014, the Financial Accounting Standards Board (FASB) issued an accounting standards update that limits the circumstances under which a disposal may be reported as a discontinued operation and requires new disclosures. This guidance will be effective in the first quarter of 2015. We do not expect the adoption of this guidance to have an impact on the presentation of our financial statements or our disclosures.

In May 2014, the FASB issued an accounting standards update that will eliminate the transaction- and industry-specific revenue recognition guidance under current U.S. GAAP and replace it with a principles based approach for determining revenue recognition. We will be required to adopt the new guidance retrospectively for annual and interim periods beginning January 1, 2017; early adoption is not permitted. We are evaluating the impact to our financial statements and disclosures.

# SCHEDULE D

## PRO FORMA CONSOLIDATED FINANCIAL STATEMENTS

## FORTIS INC.

(Unaudited)

**As at and for the six months ended June 30, 2014 and the year ended December 31, 2013**

## UNAUDITED *PRO FORMA* CONSOLIDATED FINANCIAL STATEMENTS

The following unaudited *pro forma* consolidated financial statements give effect to the acquisition (the "Acquisition") by Fortis Inc. of UNS Energy Corporation and its subsidiaries (collectively, "UNS Energy") under the purchase method of accounting. The unaudited *pro forma* consolidated balance sheet gives effect to the Acquisition as if it had closed on June 30, 2014. The unaudited *pro forma* consolidated statements of earnings for the six months ended June 30, 2014 and for the year ended December 31, 2013 give effect to the Acquisition as if it had closed on January 1, 2013.

The unaudited *pro forma* consolidated financial statements are presented for illustrative purposes only. The *pro forma* adjustments are based upon available information and certain assumptions that are believed to be reasonable in the circumstances, as described in the notes to the unaudited *pro forma* consolidated financial statements.

UNS Energy is a utility services holding company engaged, through its subsidiaries, in the electric generation and energy delivery business. The unaudited *pro forma* consolidated financial statements are based on UNS Energy's consolidated financial statements as at and for the six months ended June 30, 2014 and for the year ended December 31, 2013.

The *pro forma* information presented, including allocation of purchase price, is based on preliminary estimates of fair values of assets acquired and liabilities assumed, available information and assumptions and may be revised as additional information becomes available. The actual adjustments to the consolidated financial statements will depend on a number of factors, including additional information available and the net assets of UNS Energy as of the closing date of the Acquisition. Therefore, the actual adjustments will differ from the *pro forma* adjustments, and the differences may be material. For example, the final purchase price allocation is dependent on, among other things, the finalization of asset and liability valuations. A final determination of these fair values will reflect consideration of a final independent third-party valuation. This final valuation will be based on the actual net tangible and intangible assets and liabilities of UNS Energy that exist as of the closing date of the Acquisition. Any final adjustment may change the allocation of purchase price, which could affect the fair value assigned to the assets and liabilities and could result in a change to the unaudited *pro forma* consolidated financial statements, including a change to goodwill.

**Fortis Inc.**
***Pro forma* Consolidated Balance Sheet**
**As at June 30, 2014**
**(Unaudited)**
**(In millions of Canadian dollars)**

| | Fortis Inc. | UNS Energy | *Note* | *Pro forma* adjustments | *Pro forma* consolidated balance sheet |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| **Current assets** | | | | | |
| Cash and cash equivalents | $ 612 | $ 74 | 3[b] | $ (2,680) | **$ 123** |
| | | | 3[c] | 1,201 | |
| | | | 3[c] | (36) | |
| | | | 3[d] | 996 | |
| | | | 3[d] | (15) | |
| | | | 3[e] | (29) | |
| Accounts receivable and other current assets | 628 | 204 | | - | **832** |
| Prepaid expenses | 32 | 12 | | - | **44** |
| Inventories | 127 | 146 | | - | **273** |
| Regulatory assets | 147 | 74 | | - | **221** |
| Deferred income taxes | 30 | 92 | | - | **122** |
| | 1,576 | 602 | | (563) | **1,615** |
| **Other assets** | 290 | 106 | 3[c] | (36) | **375** |
| | | | 3[d] | 15 | |
| **Regulatory assets** | 1,775 | 173 | | - | **1,948** |
| **Deferred income taxes** | 23 | - | 3[c] | 21 | **60** |
| | | | 3[e] | 4 | |
| | | | 3[f] | 12 | |
| **Utility capital assets** | 11,852 | 3,860 | | - | **15,712** |
| **Non-utility capital assets** | 656 | - | | - | **656** |
| **Intangible assets** | 340 | 112 | | - | **452** |
| **Goodwill** | 2,074 | - | 3[b] | 1,453 | **3,527** |
| | $ 18,586 | $ 4,853 | | $ 906 | **$ 24,345** |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | | | | |
| **Current liabilities** | | | | | |
| Short-term borrowings | $ 100 | $ 25 | | $ - | **$ 125** |
| Accounts payable and other current liabilities | 901 | 279 | 3[e] | (3) | **1,177** |
| Regulatory liabilities | 155 | 58 | | - | **213** |
| Convertible debentures represented by installment receipts | 599 | - | 3[c] | (599) | **-** |
| Current installments of long-term debt | 714 | - | | - | **714** |
| Current installments of capital lease and finance obligations | 7 | 291 | | - | **298** |
| Deferred income taxes | 8 | - | | - | **8** |
| | 2,484 | 653 | | (602) | **2,535** |
| **Other Liabilities** | 678 | 196 | | - | **874** |
| **Regulatory liabilities** | 960 | 348 | 3[f] | 32 | **1,340** |
| **Deferred income taxes** | 1,088 | 564 | | - | **1,652** |
| **Long-term debt** | 6,443 | 1,790 | 3[d] | 996 | **9,229** |
| **Capital lease and finance obligations** | 415 | 75 | | - | **490** |
| | 12,068 | 3,626 | | 426 | **16,120** |
| **Shareholders' equity** | | | | | |
| Common shares | 3,849 | 949 | 3[g] | (949) | **5,598** |
| | | | 3[c] | 1,800 | |
| | | | 3[c] | (72) | |
| | | | 3[c] | 21 | |
| Preference shares | 1,229 | - | | - | **1,229** |
| Additional paid-in capital | 17 | - | | - | **17** |
| Accumulated other comprehensive loss | (69) | (5) | 3[g] | 5 | **(69)** |
| Retained earnings | 1,097 | 283 | 3[g] | (283) | **1,055** |
| | | | 3[e] | (22) | |
| | | | 3[f] | (20) | |
| | 6,123 | 1,227 | | 480 | **7,830** |
| Non-controlling interests | 395 | - | | - | **395** |
| | 6,518 | 1,227 | | 480 | **8,225** |
| | $ 18,586 | $ 4,853 | | $ 906 | **$ 24,345** |

See the accompanying notes to the unaudited *pro forma* consolidated financial statements, which are an integral part of these statements.

**Fortis Inc.**
***Pro forma* Consolidated Statement of Earnings**
**For the six months ended June 30, 2014**
**(Unaudited)**
**(In millions of Canadian dollars, except per share amounts)**

| | Fortis Inc. | UNS Energy | *Note* | *Pro forma* adjustments | *Pro forma* consolidated statement of earnings |
|---|---|---|---|---|---|
| **Revenue** | $ 2,511 | $ 790 | | $ - | **$ 3,301** |
| **Expenses** | | | | | |
| Energy supply costs | 1,082 | 310 | | - | **1,392** |
| Operating | 626 | 235 | 3[e] | (2) | **859** |
| Depreciation and amortization | 297 | 100 | | - | **397** |
| | 2,005 | 645 | | (2) | **2,648** |
| **Operating income** | 506 | 145 | | 2 | **653** |
| Other income (expenses), net | 6 | 5 | 3[e] | 4 | **15** |
| Finance charges | 247 | 48 | 3[d] | 25 | **286** |
| | | | 3[c] | (34) | |
| **Earnings before income taxes and discontinued operations** | 265 | 102 | | 15 | **382** |
| Income tax expense | 48 | 38 | 3[d] | (7) | **83** |
| | | | 3[h] | (7) | |
| | | | 3[c] | 10 | |
| | | | 3[e] | 1 | |
| **Earnings from continuing operations** | 217 | 64 | | 18 | **299** |
| Earnings from discontinued operations, net of tax | 5 | - | | | **5** |
| **Net earnings** | $ 222 | $ 64 | | $ 18 | **$ 304** |
| **Net earnings attributable to:** | | | | | |
| Non-controlling interests | $ 5 | $ - | | $ - | **$ 5** |
| Preference equity shareholders | 27 | - | | - | **27** |
| Common equity shareholders | 190 | 64 | | 18 | **272** |
| | $ 222 | $ 64 | | $ 18 | **$ 304** |
| Earnings attributable to common equity shareholders, basic | $ 190 | | | | **$ 272** |
| Effect of potential dilutive securities: preference shares | 5 | | | | **5** |
| Earnings attributable to common equity shareholders, diluted | $ 195 | | | | **$ 277** |
| **Weighted average common shares outstanding (# millions)** | | | | | |
| Basic | 214.2 | | 3[i] | 58.6 | **272.8** |
| Diluted | 221.6 | | 3[i] | 58.6 | **280.2** |
| **Earnings per common share from continuing operations** | | | | | |
| Basic | $ 0.87 | | | | **$ 0.98** |
| Diluted | $ 0.86 | | | | **$ 0.97** |
| **Earnings per common share** | | | | | |
| Basic | $ 0.89 | | | | **$ 1.00** |
| Diluted | $ 0.88 | | | | **$ 0.99** |

See the accompanying notes to the unaudited *pro forma* consolidated financial statements, which are an integral part of these statements.

**Fortis Inc.**
***Pro forma* Consolidated Statement of Earnings**
**For the year ended December 31, 2013**
**(Unaudited)**
**(In millions of Canadian dollars, except per share amounts)**

| | Fortis Inc. | UNS Energy | *Note* | *Pro forma* adjustments | *Pro forma* consolidated statement of earnings |
|---|---|---|---|---|---|
| **Revenue** | $ 4,047 | $ 1,529 | | $ - | **$ 5,576** |
| **Expenses** | | | | | |
| Energy supply costs | 1,617 | 609 | | - | **2,226** |
| Operating | 1,037 | 458 | 3[e] | (7) | **1,488** |
| Depreciation and amortization | 541 | 183 | | - | **724** |
| | 3,195 | 1,250 | | (7) | **4,438** |
| **Operating income** | 852 | 279 | | 7 | **1,138** |
| Other income (expenses), net | (31) | 8 | 3[e] | 3 | **(20)** |
| Finance charges | 389 | 96 | 3[d] | 50 | **535** |
| **Earnings before income taxes and extraordinary item** | 432 | 191 | | (40) | **583** |
| Income tax expense | 32 | 60 | 3[d] | (15) | **68** |
| | | | 3[h] | (12) | |
| | | | 3[e] | 3 | |
| **Net earnings before extraordinary item** | $ 400 | $ 131 | | $ (16) | **$ 515** |
| Extraordinary gain, net of tax | $ 20 | $ - | | $ - | **20** |
| **Net earnings** | $ 420 | $ 131 | | $ (16) | **$ 535** |
| **Net earnings attributable to:** | | | | | |
| Non-controlling interests | $ 10 | $ - | | $ - | **$ 10** |
| Preference equity shareholders | 57 | - | | - | **57** |
| Common equity shareholders | 353 | 131 | | (16) | **468** |
| | $ 420 | $ 131 | | $ (16) | **$ 535** |
| Earnings attributable to common equity shareholders, basic | $ 353 | | | | **$ 468** |
| Effect of potential dilutive securities: preference shares | 13 | | | | **13** |
| Anti-dilutive impact: preference shares | (4) | | | | **(4)** |
| Earnings attributable to common equity shareholders, diluted | $ 362 | | | | **$ 477** |
| **Weighted average common shares outstanding (# millions)** | | | | | |
| Basic | 202.5 | | 3[i] | 58.6 | **261.1** |
| Diluted | 209.3 | | 3[i] | 58.6 | **267.9** |
| **Earnings per common share from continuing operations** | | | | | |
| Basic | $ 1.64 | | | | **$ 1.72** |
| Diluted | $ 1.63 | | | | **$ 1.71** |
| **Earnings per common share** | | | | | |
| Basic | $ 1.74 | | | | **$ 1.79** |
| Diluted | $ 1.73 | | | | **$ 1.78** |

See the accompanying notes to the unaudited *pro forma* consolidated financial statements, which are an integral part of these statements.

## 1. BASIS OF PRESENTATION

The accompanying unaudited *pro forma* consolidated financial statements give effect to the acquisition (the "Acquisition") by Fortis Inc. ("Fortis" or the "Corporation") of UNS Energy Corporation and its subsidiaries (collectively, "UNS Energy") as described in the Business Acquisition Report ("BAR") dated September 2, 2014. The accompanying unaudited *pro forma* consolidated financial statements have been prepared by management of Fortis and are derived from the unaudited and audited consolidated financial statements of Fortis as at and for the six months ended June 30, 2014 and for the year ended December 31, 2013, respectively, and the unaudited and audited consolidated financial statements of UNS Energy as at and for the six months ended June 30, 2014 and for the year ended December 31, 2013, respectively.

The accompanying unaudited *pro forma* consolidated financial statements utilize accounting policies that are consistent with those disclosed in the Corporation's audited consolidated financial statements and were prepared in accordance with accounting principles generally accepted in the United States.

The Acquisition has been accounted for using the purchase method. The purchase price is primarily based upon the regulated assets at the date of closing. Based on the purchase price as detailed in the merger agreement dated December 11, 2013, the estimated net purchase price for the equity of UNS Energy is approximately $2.7 billion (Note 3[a]).

The accompanying unaudited *pro forma* consolidated balance sheet and unaudited *pro forma* consolidated statements of earnings reflect the Acquisition effected on June 30, 2014 and January 1, 2013, respectively. The accompanying unaudited *pro forma* consolidated financial statements are not necessarily indicative of the results that would have been achieved if the transactions reflected therein had been completed on the dates indicated or the results which may be obtained in the future. For instance, the actual purchase price allocation will reflect the fair value, at the purchase date, of the assets acquired and liabilities assumed based upon the Corporation's evaluation of such assets and liabilities following the closing of the Acquisition and, accordingly, the final purchase price allocation, as it relates principally to goodwill, may differ materially from the preliminary allocation reflected herein.

The accompanying unaudited *pro forma* consolidated financial statements should be read in conjunction with the description of the transaction described in the BAR; the audited and unaudited consolidated financial statements of UNS Energy, including the notes thereto, included in the BAR; and the audited and unaudited consolidated financial statements of Fortis, including the notes thereto.

The underlying assumptions for the *pro forma* adjustments provide a reasonable basis for presenting the significant financial effect directly attributable to the Acquisition. These *pro forma* adjustments are tentative and are based on currently available financial information and certain estimates and assumptions. The actual adjustments to the consolidated financial statements will depend on a number of factors. Therefore, it is expected that the actual adjustments will differ from the *pro forma* adjustments, and the differences may be material.

## 2. DESCRIPTION OF TRANSACTION

Pursuant to an agreement and plan of a merger between Fortis, certain Fortis subsidiaries and UNS Energy, the Corporation indirectly purchased all of the outstanding common shares of UNS Energy for US$60.25 per share. The net purchase price, including estimated acquisition costs of $29 million, was approximately $2.7 billion (Note 3[a]). The Corporation has also assumed UNS Energy debt, which was approximately $2.2 billion (Note 3[a]) as at June 30, 2014.

The accompanying unaudited *pro forma* consolidated financial statements assume that the Acquisition was financed through the proceeds from a $1.8 billion common share issuance (as further described below), with the balance initially funded through debt. The Corporation currently expects that up to approximately $700 million of such debt will be permanently refinanced with the net proceeds from post-closing preferred share issuances.

The common equity is assumed to be issued through the conversion of the 4% convertible unsecured subordinated debentures ("Convertible Debentures") represented by installment receipts, as described in the BAR. The Corporation has also arranged a $2.0 billion committed bridge facility which, together with the Convertible Debentures represented by installments receipts, were sufficient to fund the net purchase price and close the Acquisition. The accompanying unaudited *pro forma* consolidated financial statements: (i) reflect the estimated costs of arranging the Convertible Debentures and bridge facility in acquisition costs (Note 3[e]); and (ii) assume that the Convertible Debentures were issued and immediately fully converted into Fortis common shares at the assumed closing dates of the Acquisition. Therefore, the accompanying unaudited *pro forma* consolidated financial statements do not recognize interest costs associated with the Convertible Debentures.

The Corporation has also agreed with the regulator of UNS Energy that it will inject US$220 million of equity into the regulated subsidiaries of UNS Energy within 60 days after the closing of the Acquisition. This amount will initially be funded from the Corporation's $1 billion committed revolving credit facility. The above-noted equity injection has not been reflected in the accompanying unaudited *pro forma* consolidated financial statements because: (i) it is effectively an ancillary post-closing matter; and (ii) the primary effect of the equity injection is to shift net debt from the regulated utilities of UNS Energy to the Corporation with no significant impact on consolidated net debt.

## 3. *PRO FORMA* ASSUMPTIONS AND ADJUSTMENTS

### [a] Purchase Price and Financing Structure

The following is the estimated net purchase price and assumed financing structure for the Acquisition. These estimates have been reflected in the accompanying unaudited *pro forma* consolidated financial statements.

| **Estimated Net Purchase Price** | |
|---|---|
| Unadjusted purchase price | $ 4,861 |
| Estimated acquisition costs (Note 3[e]) | 29 |
| Estimated net purchase price, before assumed debt | 4,890 |
| Assumed long-term debt of UNS Energy (Note 2) | (2,181) |
| Estimated net purchase price (Notes 1 and 2) | $ 2,709 |

| **Estimated Net Funding Requirements** | |
|---|---|
| Estimated net purchase price | $ 2,709 |
| Assumed long-term debt of UNS Energy (Note 2) | 2,181 |
| Common share issuance costs (Note 3[c]) | 72 |
| Incremental long-term debt issuance costs (Note 3[d]) | 15 |
| Estimated net funding requirements | $ 4,977 |

| **Assumed Financing Structure** | |
|---|---|
| Assumed long-term debt of UNS Energy (Note 2) | $ 2,181 |
| Common share issuance (Note 3[c]) | 1,800 |
| Incremental long-term debt (Note 3[d]) | 996 |
| | $ 4,977 |

## 3. *PRO FORMA* ASSUMPTIONS AND ADJUSTMENTS (Continued)

### [b] Allocation of estimated net purchase price

The estimated net purchase price has been allocated to the estimated fair values of UNS Energy net assets and liabilities as at June 30, 2014 in accordance with the purchase method, as follows:

| | UNS Energy | Fair Value and Other Adjustments | Net Total |
|---|---|---|---|
| **Assets acquired:** | | | |
| Cash and cash equivalents | $ 74 | $ - | $ 74 |
| Accounts receivable | 204 | - | 204 |
| Prepaid expenses | 12 | - | 12 |
| Inventories | 146 | - | 146 |
| Regulatory assets | 74 | - | 74 |
| Deferred income taxes | 92 | - | 92 |
| **Total current assets** | 602 | - | 602 |
| **Other assets** | 106 | - | 106 |
| **Regulatory assets** | 173 | - | 173 |
| **Utility capital assets** | 3,860 | - | 3,860 |
| **Intangible assets** | 112 | - | 112 |
| | $ 4,853 | $ - | $ 4,853 |
| **Liabilities assumed:** | | | |
| Short-term borrowings | $ 25 | $ - | $ 25 |
| Accounts payable and other current liabilities | 279 | - | 279 |
| Regulatory liabilities | 58 | - | 58 |
| Current installments of capital lease and finance obligations | 291 | - | 291 |
| **Total current liabilities** | 653 | - | 653 |
| **Other liabilities** | 196 | - | 196 |
| **Regulatory liabilities** | 348 | - | 348 |
| **Deferred income taxes** | 564 | - | 564 |
| **Long-term debt** | 1,790 | - | 1,790 |
| **Capital lease and finance obligations** | 75 | - | 75 |
| | $ 3,626 | $ - | $ 3,626 |
| **Net assets at fair value, as at June 30, 2014** | | | $ 1,227 |
| **Estimated net purchase price, before assumed debt and acquisition costs** | | | 2,680 |
| **Goodwill** | | | $ 1,453 |

### 3. *PRO FORMA* ASSUMPTIONS AND ADJUSTMENTS (Continued)

**[b] Allocation of estimated net purchase price (continued)**

UNS Energy is a rate-regulated entity. The determination of revenues and earnings is based on regulated rates of return that are applied to historic values and does not change with a change of ownership. Therefore, no fair market value adjustments have been recognized as part of the purchase price on UNS Energy's assets and liabilities to be acquired because all of the economic benefits and obligations associated with them beyond regulated thresholds accrue to UNS Energy's customers. Consequently, the fair value of UNS Energy's assets and liabilities is assumed to be equal to their carrying amounts.

The excess of the estimated net purchase price of the Acquisition, before assumed debt and acquisition costs, over the assumed fair value of net assets acquired from UNS Energy is classified as goodwill on the accompanying unaudited *pro forma* consolidated balance sheet.

**[c] Common share issuance**

Assumed financing for the Acquisition includes the issuance, through the exercise of conversion rights under the Convertible Debentures, of approximately 58.6 million Fortis common shares at $30.72 per share for gross proceeds of approximately $1.8 billion. Underwriting and agency costs as well as private placement commitment fees are 4% of gross proceeds in the aggregate or approximately $72 million and will result in a corresponding deferred income tax asset of approximately $21 million based on the Corporation's statutory income tax rate of 29%. Gross proceeds of the first installment of the Convertible Debentures offering received in January 2014 were approximately $599 million, less half of the total underwriting and agency costs of approximately $36 million. The gross proceeds of the final installment payment are expected to be, in aggregate, approximately $1.2 billion, less the remaining $36 million of the underwriting and agency costs.

Approximately $34 million ($24 million after tax) in interest expense associated with the Convertible Debentures was recognized in earnings for the six months ended June 30, 2014. These finance charges have been removed from the unaudited *pro forma* consolidated statements of earnings of the Corporation on the basis that these finance charges are non-recurring in nature, due to the assumption of full conversion of the Convertible Debentures into common shares.

**[d] Incremental long-term debt**

The remaining portion of financing for the Acquisition has been assumed to be through the issuance of approximately $996 million of debt. Estimated debt issuance costs of approximately $15 million have been recognized as a long-term other asset. The interest rate is estimated at 5%, which would result in incremental interest expense for the year ended December 31, 2013 and for the six months ended June 30, 2014 of $50 million and $25 million, respectively. Incremental interest expense would result in corresponding deferred income tax assets of $15 million and $7 million, respectively, based on the Corporation's statutory income tax rate of 29%.

## 3. *PRO FORMA* ASSUMPTIONS AND ADJUSTMENTS (Continued)

### [e] Acquisition costs

Acquisition costs at the time of closing are estimated at approximately $29 million, or approximately $22 million net of income tax. The acquisition costs will create a deferred income tax asset of approximately $4 million and a reduction in current income taxes payable of $3 million. Acquisition costs are composed of estimated investment banking, acquisition bridge facility drawdown fees, accounting, tax, legal and other costs associated with the completion of the Acquisition. These costs have been included as a *pro forma* adjustment to retained earnings as opposed to being reflected in the unaudited *pro forma* consolidated statements of earnings of the Corporation on the basis that these expenses are directly incremental to the acquisition of UNS Energy and are non-recurring in nature.

For the year ended December 31, 2013, the Corporation and UNS Energy recognized acquisition-related expenses of approximately $3 million ($2 million after tax) and $7 million ($5 million after tax), respectively. For the six months ended June 30, 2014, the Corporation and UNS Energy recognized acquisition-related expenses of approximately $4 million ($3 million after tax) and $2 million ($2 million after tax), respectively. These acquisition-related expenses have been removed from the unaudited *pro forma* consolidated statements of earnings of the Corporation on the basis that these expenses were directly incremental to the acquisition of UNS Energy and are non-recurring in nature.

### [f] UNS Energy Customer Benefits

The Corporation has agreed with the regulator of UNS Energy's regulated subsidiaries that it will provide US$30 million of benefits to customers in the form of bill credits over a period of five years following the closing of the Acquisition. The customer benefits will be fully expensed immediately after closing and will result in a regulatory liability of $32 million and a deferred income tax asset of approximately $12 million. This *pro forma* adjustment has been recognized as an adjustment to retained earnings as at June 30, 2014 as it is non-recurring in nature.

### [g] UNS Energy historical shareholders' equity

The historical shareholders' equity of UNS Energy, which includes retained earnings, accumulated other comprehensive loss and common shares, has been eliminated on consolidation.

### [h] Income taxes

Income taxes applicable to the *pro forma* adjustments are calculated at Fortis' average tax rates of 29% (CDN rate) and 38% (US rate) for the year ended December 31, 2013 and for the six months ended June 30, 2014. To reflect an income tax benefit related to intercompany financing, a reduction in income tax expense of $12 million and $7 million has been recorded in the accompanying unaudited *pro forma* consolidated statement of earnings for the year ended December 31, 2013 and for the six months ended June 30, 2014, respectively.

## 3. *PRO FORMA* ASSUMPTIONS AND ADJUSTMENTS (Continued)

### [h] Income taxes (continued)

The deferred income tax asset and liability is the cumulative amount of tax applicable to temporary differences between the accounting and tax values of assets and liabilities. Deferred income tax assets and liabilities are measured at the tax rates expected to apply when these differences reverse. For the purpose of the accompanying unaudited *pro forma* consolidated financial statements, deferred income tax rates of 29% (CDN rate) and 38% (US rate) have been used.

### [i] Earnings per common share

The calculation of the *pro forma* earnings per common share for the year ended December 31, 2013, and for the six months ended June 30, 2014 reflects the assumed issuance of approximately 58.6 million Fortis common shares as if the issuance had taken place as at January 1, 2013.

### [j] Foreign exchange translation

The assets and liabilities of UNS Energy, which has a US dollar functional currency, are translated at the exchange rate in effect as at the unaudited *pro forma* consolidated balance sheet date. Revenue and expenses of UNS Energy's operations are translated at the average exchange rate in effect during the reporting period. The following exchange rates were utilized for the unaudited *pro forma* consolidated financial statements:

| | |
|---|---|
| **Balance Sheet (US$ to C$)** | |
| Closing rate - June 30, 2014 | 1.07 |
| **Income Statement (US$ to C$)** | |
| Average rate - January 1, 2013 to December 31, 2013 | 1.03 |
| Average rate - January 1, 2014 to June 30, 2014 | 1.10 |