TUCSON ELECTRIC POWER CO
Form 10-Q
July 31, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2015
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to .

Commission File Number 1-5924
TUCSON ELECTRIC POWER COMPANY
(Exact name of registrant as specified in its charter)

Arizona	86-0062700
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

88 East Broadway Boulevard, Tucson, AZ 85701
(Address of principal executive offices)(Zip Code)
Registrant's telephone number, including area code: (520) 571-4000
(Former name, former address and former fiscal year, if changed since last report): N/A

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):
Large Accelerated Filer ¨ Accelerated Filer ¨ Non-accelerated Filer x Smaller Reporting Company ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No x
All shares of outstanding common stock of Tucson Electric Power Company are held by its parent company, UNS Energy Corporation, which is an indirect, wholly owned subsidiary of Fortis Inc. There were 32,139,434 shares of common stock, no par value, outstanding as of July 30, 2015.

Table of Contents

DEFINITIONS

The abbreviations and acronyms used in the second quarter 2015 Form 10-Q are defined below:

2010 Credit Agreement	The 2010 Credit Agreement consists of a $200 million revolving credit and LOC facility together with an $82 million LOC facility to support tax-exempt bonds
2010 TEP Reimbursement Agreement	Reimbursement Agreement, dated December 14, 2010, between TEP, as borrower, and a financial institution
2013 Covenants Agreement	A Lender Rate Mode Covenants Agreement between TEP and the purchasers of $100 million of unsecured tax-exempt bonds that were issued on behalf of TEP in November 2013 and sold in a private placement
2013 TEP Rate Order	A rate order issued by the ACC resulting in a new rate structure for TEP, effective July 1, 2013
2014 Credit Agreement	The 2014 Credit Agreement consisted of a $70 million revolving credit commitment and a $130 million term loan commitment portion. The term loan was terminated upon repayment in April 2015. The revolver credit portion was also terminated after repayment.
ACC	Arizona Corporation Commission
APS	Arizona Public Service Company
BART	Best Available Retrofit Technology
Base O&M	A non-GAAP financial measure that represents the fundamental level of operating and maintenance expense related to our business
Base Rates	The portion of TEP’s Retail Rates attributed to generation, transmission, distribution, and customer costs. Base Rates exclude authorized charges designed to recover specific costs that are passed through to customers including fuel and purchased energy costs, energy efficiency program costs, certain environmental compliance costs, and a portion of renewable energy costs
Cooling Degree Days	An index used to measure the impact of weather on energy usage calculated by subtracting 75 from the average of the high and low daily temperatures
DG	Distributed Generation
DSM	Demand Side Management
ECA	Environmental Compliance Adjustor
EE	Energy Efficiency
EPA	Environmental Protection Agency
FERC	Federal Energy Regulatory Commission
Fortis	Fortis Inc., a corporation incorporated under the Corporations Act of Newfoundland and Labrador, Canada, whose principal executive offices are located at Fortis Place, Suite 1100, 5 Springdale Street, St. John's, NL A1E 0E4
Four Corners	Four Corners Generating Station
GBtu	Billion British thermal units
GWh	Gigawatt-hour(s)
Gila River Unit 3	Unit 3 of the Gila River Generating Station
Heating Degree Days	An index used to measure the impact of weather on energy usage calculated by subtracting the average of the high and low daily temperatures from 65
kV	Kilovolt(s)
kWh	Kilowatt-hour(s)
LFCR	Lost Fixed Cost Recovery
LOC	Letter(s) of Credit
Merger	The acquisition of UNS Energy in 2014 pursuant to the Agreement and Plan of Merger between UNS Energy Corporation and FortisUS Inc.
MMBtu	Million British thermal units

MW	Megawatt(s)
MWh	Megawatt-hour(s)
Navajo	Navajo Generating Station
PNM	Public Service Company of New Mexico
ppb	Parts per billion

PPFAC	Purchased Power and Fuel Adjustment Clause
Regional Haze Rules	Rules promulgated by the EPA to improve visibility at national parks and wilderness areas
RES	Renewable Energy Standard
Retail Rates	Rates designed to allow a regulated utility an opportunity to recover its reasonable operating and capital costs and earn a return on its utility plant in service
San Juan	San Juan Generating Station
SCR	Selective Catalytic Reduction
SES	Southwest Energy Solutions, Inc.
SJCC	San Juan Coal Company
SNCR	Selective Non-Catalytic Reduction
Springerville	Springerville Generating Station
Springerville Coal Handling Facilities	Coal handling facilities at Springerville used in common by all four Springerville units
Springerville Coal Handling Facilities Leases	Leases previously in place for coal handling facilities at Springerville used in common by all four Springerville units
Springerville Common Facilities	Facilities at Springerville used in common by all four Springerville units
Springerville Common Facilities Leases	Leveraged lease arrangements relating to an undivided one-half interest in certain Springerville Common Facilities
Springerville Unit 1	Unit 1 of the Springerville Generating Station
Springerville Unit 1 Leases	Leveraged lease arrangements that were previously in place relating to Springerville Unit 1 and an undivided one-half interest in certain Springerville Common Facilities
Springerville Unit 2	Unit 2 of the Springerville Generating Station
Springerville Unit 3	Unit 3 of the Springerville Generating Station
Springerville Unit 4	Unit 4 of the Springerville Generating Station
SRP	Salt River Project Agricultural Improvement and Power District
Sundt	H. Wilson Sundt Generating Station
Sundt Unit 4	Unit 4 of the H. Wilson Sundt Generating Station
TEP	Tucson Electric Power Company, the principal subsidiary of UNS Energy Corporation
Third-Party Owners	Wilmington Trust Company and William J. Wade, as Owner Trustee and Co-trustee under a separate trust agreement with each of the remaining two owner participants, Alterna Springerville LLC (Alterna) and LDVF1 TEP LLC (LDVF1)
Tri-State	Tri-State Generation and Transmission Association, Inc.
UNS Electric	UNS Electric, Inc., an indirect wholly-owned subsidiary of UNS Energy
UNS Energy	UNS Energy Corporation
UNS Energy affiliates	Affiliated subsidiaries of UNS Energy including UNS Electric, Inc., UNS Gas, Inc., and Southwest Energy Solutions, Inc.
UNS Gas	UNS Gas, Inc., an indirect wholly-owned subsidiary of UNS Energy

Table of Contents

FORWARD-LOOKING INFORMATION

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

Forward-looking statements involve risks and uncertainties, which could cause actual results or outcomes to differ materially from those expressed therein. We express our expectations, beliefs, and projections in good faith and believe them to have a reasonable basis. However, we make no assurances that management’s expectations, beliefs or projections will be achieved or accomplished. We have identified the following important factors that could cause actual results to differ materially from those discussed in our forward-looking statements. These may be in addition to other factors and matters discussed in: Part I, Item 1A. of our 2014 Form 10-K; Part II, Item 1A. Risk Factors; Part I, Item 2. Management’s Discussion and Analysis; and other parts of this report. These factors include: state and federal regulatory and legislative decisions and actions; changes in, and compliance with, environmental laws, regulations, decisions, and policies that could increase operating and capital costs, reduce generating facility output or accelerate generating facility retirements; regional economic and market conditions which could affect customer growth and energy usage; changes in energy consumption by retail customers; weather variations affecting energy usage; the cost of debt and equity capital and access to capital markets; the performance of the stock market and changing interest rate environment, which affect the value of our pension and other retiree benefit plan assets and the related contribution requirements and expense; the inability to make additions to our existing high voltage transmission system; unexpected increases in O&M expense; resolution of pending litigation matters; changes in accounting standards; changes in critical accounting estimates; the ongoing impact of mandated energy efficiency and distributed generation initiatives; changes to long-term contracts; the cost of fuel and power supplies; ability to obtain coal from our suppliers; cyber attacks or challenges to our information security; and the performance of TEP's generating plants.

Table of Contents

PART I
ITEM 1. FINANCIAL STATEMENTS
TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (Unaudited)
(Amounts in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Operating Revenues				
Electric Retail Sales	$264,297	$257,790	$465,920	$443,805
Electric Wholesale Sales	47,674	32,555	89,136	74,639
Other Revenues	28,204	31,273	58,512	58,687
Total Operating Revenues	340,175	321,618	613,568	577,131
Operating Expenses				
Fuel	77,067	68,334	147,636	135,964
Purchased Power	36,885	52,906	67,407	75,521
Transmission and Other PPFAC Recoverable Costs	6,873	3,552	11,580	7,461
Increase (Decrease) to Reflect PPFAC Recovery Treatment	7,532	(13,061)	10,781	(14,791)
Total Fuel and Purchased Energy	128,357	111,731	237,404	204,155
Operations and Maintenance	85,655	79,772	168,300	161,117
Depreciation	34,219	31,080	68,952	61,891
Amortization	4,619	7,377	10,181	14,476
Taxes Other Than Income Taxes	12,935	12,005	26,146	23,840
Total Operating Expenses	265,785	241,965	510,983	465,479
Operating Income	74,390	79,653	102,585	111,652
Other Income (Deductions)				
Interest Income	22	165	51	174
Other Income	1,436	2,187	2,058	4,099
Other Expense	(656)	(2,694)	(1,118)	(4,809)
Appreciation (Depreciation) in Value of Investments	(539)	624	241	879
Total Other Income (Deductions)	263	282	1,232	343
Interest Expense				
Long-Term Debt	15,706	15,507	30,116	29,747
Capital Leases	1,007	3,925	2,012	7,846
Other Interest Expense	430	140	864	453
Interest Capitalized	(741)	(1,104)	(1,196)	(2,028)
Total Interest Expense	16,402	18,468	31,796	36,018
Income Before Income Taxes	58,251	61,467	72,021	75,977
Income Tax Expense	20,425	22,742	24,766	28,080
Net Income	$37,826	$38,725	$47,255	$47,897

The accompanying notes are an integral part of these financial statements.

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)
(Amounts in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Comprehensive Income				
Net Income	$37,826	$38,725	$47,255	$47,897
Other Comprehensive Income (Loss)				
Net Changes in Fair Value of Cash Flow Hedges:				
Net of Income Tax (Expense) Benefit of ($282) and ($321)	441	494		
Net of Income Tax (Expense) Benefit of ($294) and ($667)			455	975
Supplemental Executive Retirement Plan Net Loss and Prior Service Cost Amortization:				
Net of Income Tax (Expense) Benefit of ($38) and ($15)	61	25		
Net of Income Tax (Expense) Benefit of ($75) and ($30)			121	49
Total Other Comprehensive Income (Loss), Net of Taxes	502	519	576	1,024
Total Comprehensive Income	$38,328	$39,244	$47,831	$48,921

The accompanying notes are an integral part of these financial statements.

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(Amounts in thousands)

	Six Months Ended June 30, 2015	2014
Cash Flows from Operating Activities		
Net Income	$47,255	$47,897
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation Expense	68,952	61,891
Amortization Expense	10,181	14,476
Amortization of Deferred Debt-Related Costs included in Interest Expense	1,499	1,285
Provision for Springerville Unit 1 - Third-Party Owners Unrealized Revenue	11,170	—
Use of Renewable Energy Credits for Compliance	12,014	9,884
Deferred Income Taxes	23,835	28,081
Pension and Retiree Expense	9,294	6,824
Pension and Retiree Funding	(9,886)	(5,522)
Allowance for Equity Funds Used During Construction	(1,419)	(3,524)
LFCR and DSM Revenues	(8,298)	(7,731)
Increase (Decrease) to Reflect PPFAC Recovery	10,781	(14,791)
Changes in Current Assets and Current Liabilities:		
Accounts Receivable	(44,956)	(35,498)
Materials, Supplies and Fuel Inventory	(3,326)	(3,936)
Accounts Payable	2,327	6,019
Interest Accrued	(1,132)	1,320
Taxes Other Than Income Taxes	3,760	5,247
Other, net	(3,214)	1,120
Net Cash Flows – Operating Activities	128,837	113,042
Cash Flows from Investing Activities		
Capital Expenditures	(194,915)	(157,161)
Purchase of Intangibles—Renewable Energy Credits	(15,002)	(13,782)
Purchase of Springerville Unit 1 Lease Assets	(45,753)	—
Purchase of Springerville Coal Handling Facilities Lease Assets	(120,312)	—
Proceeds from Sale of Springerville Coal Handling Facilities	23,656	—
Contributions in Aid of Construction	3,297	7,443
Other, net	—	2,879
Net Cash Flows—Investing Activities	(349,029)	(160,621)
Cash Flows from Financing Activities		
Proceeds from Borrowings Under Revolving Credit Facility	148,000	105,000
Repayments of Borrowings Under Revolving Credit Facility	(233,000)	(105,000)
Proceeds from Borrowings Under Term Loan	130,000	—
Repayments of Borrowings Under Term Loan	(130,000)	—
Proceeds from Issuance of Long-Term Debt	299,019	149,168
Repayments of Long-Term Debt	(130,000)	—
Payments of Capital Lease Obligations	(12,440)	(83,204)
Payment of Debt Issue/Retirement Costs	(2,920)	(1,641)
Contribution from Parent	180,000	—
Other, net	898	656
Net Cash Flows—Financing Activities	249,557	64,979

Net Increase (Decrease) in Cash and Cash Equivalents	29,365	17,400
Cash and Cash Equivalents, Beginning of Year	74,170	25,335
Cash and Cash Equivalents, End of Period	$103,535	$42,735

The accompanying notes are an integral part of these financial statements.

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)
(Amounts in thousands)

	June 30, 2015	December 31, 2014
ASSETS		
Utility Plant		
Plant in Service	$5,445,939	$5,175,148
Utility Plant Under Capital Leases	131,704	667,157
Construction Work in Progress	150,228	109,070
Total Utility Plant	5,727,871	5,951,375
Less Accumulated Depreciation and Amortization	(2,153,652)	(2,052,216)
Less Accumulated Amortization of Capital Lease Assets	(97,416)	(473,969)
Total Utility Plant—Net	3,476,803	3,425,190
Investments and Other Property	37,879	37,599
Current Assets		
Cash and Cash Equivalents	103,535	74,170
Accounts Receivable—Customer	90,747	78,061
Accounts Receivable—Other	25,011	16,437
Accounts Receivable—Due from Affiliates	5,311	5,382
Unbilled Accounts Receivable	60,490	36,804
Allowance for Doubtful Accounts-Customer	(4,875)	(4,885)
Allowance for Doubtful Accounts-Other	(11,170)	—
Fuel Inventory	32,102	36,368
Materials and Supplies	89,786	86,750
Regulatory Assets—Current	66,423	69,383
Deferred Income Taxes—Current	80,286	102,006
Derivative Instruments	3,456	1,633
Assets Held for Sale	21,550	—
Other	26,817	21,871
Total Current Assets	589,469	523,980
Regulatory and Other Assets		
Regulatory Assets—Noncurrent	221,499	223,192
Derivative Instruments	994	300
Other Assets	23,420	22,161
Total Regulatory and Other Assets	245,913	245,653
Total Assets	$4,350,064	$4,232,422

The accompanying notes are an integral part of these financial statements.

(Continued)

4

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)
(Amounts in thousands)

	June 30, 2015	December 31, 2014
CAPITALIZATION AND OTHER LIABILITIES		
Capitalization		
Common Stock Equity	$1,443,610	$1,215,779
Capital Lease Obligations	55,295	69,438
Long-Term Debt	1,462,956	1,372,414
Total Capitalization	2,961,861	2,657,631
Current Liabilities		
Current Obligations Under Capital Leases	14,643	173,822
Current Maturities of Long-Term Debt	78,600	—
Borrowings Under Revolving Credit Facilities	—	85,000
Accounts Payable—Trade	100,902	110,480
Accounts Payable—Due to Affiliates	3,171	2,933
Accrued Taxes Other than Income Taxes	39,869	36,110
Accrued Employee Expenses	19,662	15,679
Accrued Interest	14,725	21,021
Regulatory Liabilities—Current	33,022	38,847
Customer Deposits	19,723	20,339
Derivative Instruments	15,583	18,874
Other	13,941	9,673
Total Current Liabilities	353,841	532,778
Deferred Credits and Other Liabilities		
Deferred Income Taxes—Noncurrent	497,759	491,546
Regulatory Liabilities—Noncurrent	311,662	321,186
Pension and Other Postretirement Benefits	134,212	138,319
Derivative Instruments	5,847	6,288
Other	84,882	84,674
Total Deferred Credits and Other Liabilities	1,034,362	1,042,013
Commitments and Contingencies		
Total Capitalization and Other Liabilities	$4,350,064	$4,232,422

The accompanying notes are an integral part of these financial statements.

(Concluded)

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDER'S EQUITY (Unaudited)
(Amounts in thousands)

	Common Stock	Capital Stock Expense	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholder's Equity
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

	Common Stock	Capital Stock Expense	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholder's Equity
Balances at December 31, 2014	$1,116,539	$(6,357)	$111,523	$(5,926)	$1,215,779
Net Income			47,255		47,255
Other Comprehensive Income, Net of Tax				576	576
Contribution from Parent	180,000				180,000
Balances at June 30, 2015	$1,296,539	$(6,357)	$158,778	$(5,350)	$1,443,610

The accompanying notes are an integral part of these financial statements.

Table of Contents

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. NATURE OF OPERATIONS AND FINANCIAL STATEMENT PRESENTATION

TEP is a regulated utility that generates, transmits, and distributes electricity to approximately 417,000 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. TEP is a wholly owned subsidiary of UNS Energy Corporation (UNS Energy), a utility services holding company. UNS Energy is an indirect wholly owned subsidiary of Fortis Inc. (Fortis), which is a leader in the North American electric and gas utility business.

BASIS OF PRESENTATION

We prepared our condensed consolidated financial statements according to generally accepted accounting principles in the United States of America (GAAP), including specific accounting guidance for regulated operations, and the Securities and Exchange Commission's (SEC) interim reporting requirements. The condensed consolidated financial statements include the accounts of TEP and its subsidiaries. In the consolidation process, accounts of the parent and subsidiaries are combined and intercompany balances and transactions are eliminated. TEP jointly owns several generating stations and transmission facilities with both affiliated and non-affiliated entities. TEP's proportionate share of jointly owned facilities is recorded as Utility Plant on the Condensed Consolidated Balance Sheets, and our proportionate share of the operating costs associated with these facilities is included in the Condensed Consolidated Statements of Income. 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 2014 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. Certain amounts from prior periods have been reclassified to conform to the current period presentation. Most notably, in the third quarter of 2014 following the acquisition of UNS Energy by Fortis, TEP elected to change its method of reporting cash flows from the direct to the indirect method to conform to the presentation method used by Fortis.

RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

In 2015, we adopted accounting guidance that limits the circumstances under which a disposal may be reported as a discontinued operation and requires new disclosures. The adoption of this guidance did not have any impact on our disclosures, financial condition, results of operations, or cash flows as we did not have any activities that required application of this accounting guidance.

NOTE 2. 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. 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.

COST RECOVERY MECHANISMS

Purchased Power and Fuel Adjustment Clause

The ACC adjusts TEP's Purchased Power and Fuel Adjustment Clause (PPFAC) rate annually each April 1 for the subsequent 12-month period. The PPFAC rates during the periods reported were as follows:

Period	Cents per kWh	
April 2015 through March 2016	0.68	
October 2014 through March 2015 [1]	0.50	
May 2014 through September 2014 [1]	0.10	
July 2013 through April 2014 [2]	(0.14	)

7

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

(1) The ACC approved a two-step increase to shift a higher level of recovery into the winter season.
(2) The effective date of the 2012 PPFAC rate reduction was deferred to coincide with the effective date of the 2013 Rate Order.

In September 2011, a fire at the underground mine providing coal to the 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. As of June 30, 2015, 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 the remaining incremental fuel costs, not reimbursed by insurance, through its PPFAC.

Energy Efficiency Standards

TEP is 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 an annual performance incentive. TEP records its annual DSM performance incentive in March of each year, with $3 million recorded in 2015 and $2 million in 2014 related to performance in each respective prior calendar year. This performance incentive is included in Electric Retail Sales in the Condensed Consolidated Statements of Income.

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 kilowatt-hours (kWh) sales as a result of implementing ACC-approved EE programs and distributed generation (DG) targets. TEP records a regulatory asset and recognizes LFCR revenues when the amounts are verifiable regardless of when the lost retail kWh sales occur. For recovery of the LFCR regulatory asset, TEP is required to file an annual LFCR adjustment request with the ACC for the LFCR revenues recognized in the prior year. The recovery is subject to a year-over-year cap of 1% of TEP's total retail revenues.

TEP recorded a regulatory asset and recognized LFCR revenues of $3 million and $5 million in the three and six months ended June 30, 2015. TEP recorded $1 million and $6 million in the three and six months ended June 30, 2014. LFCR revenues are included in Electric Retail Sales in the Condensed Consolidated Statements of Income.

TEP requested and the ACC approved, in May 2015, approximately $9 million for lost fixed costs incurred in 2014; recovery was approved with new LFCR rates effective August 2015. TEP requested and the ACC approved, in May 2014, approximately $5 million for lost fixed costs incurred in 2013; recovery was approved with new LFCR rates effective August 2014.

REGULATORY ASSETS

Upon expiration of Springerville Generating Station Unit 1 (Springerville Unit 1) capital leases in January 2015, TEP recorded a regulatory asset of $25 million for unamortized leasehold improvement costs that relate to third-party ownership interests. These leasehold improvements, previously recorded in Plant in Service on the balance sheet, represent investments TEP made through the end of the lease term to ensure that the Springerville Unit 1 facilities continued providing safe, reliable service to TEP's customers. In its 2013 Rate Case, TEP received ACC authorization to recover these costs over a 10-year amortization period for leasehold improvements at the Springerville Unit 1. TEP owns a 49.5% undivided interest in Springerville Unit 1.

NOTE 3. RELATED PARTY TRANSACTIONS

TEP engages in various transactions with Fortis, UNS Energy and its affiliated subsidiaries including UniSource Energy Services, Inc., UNS Electric, Inc. (UNS Electric), UNS Gas, Inc. (UNS Gas), and Southwest Energy Solutions, Inc. (SES) (collectively, UNS Energy affiliates). These transactions include the sale and purchase of power, common cost allocations, and the provision of corporate and other labor related services.

8

Table of Contents

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes related party balances included in the Condensed Consolidated Balance Sheets:

	Balances at	
(in millions)	June 30, 2015	December 31, 2014
Receivables from Related Parties		
UNS Electric	$4	$4
UNS Gas	1	1
Total Due from Related Parties	$5	$5
Payables to Related Parties		
SES	$2	$2
UNS Energy	1	—
UNS Electric	—	1
Total Due to Related Parties	$3	$3

The following table summarizes related party transactions included in the Condensed Consolidated Statements of Income:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in millions)	2015	2014	2015	2014
Wholesale Sales - TEP to UNS Electric (1)	$2	$1	$4	$1
Wholesale Sales - UNS Electric to TEP (1)	—	—	1	1
Control Area Services - TEP to UNS Electric (2)	—	—	1	1
Common Costs - TEP to UNS Energy Affiliates (3)	3	3	6	6
Supplemental Workforce - SES to TEP (4)	4	3	8	7
Corporate Services - UNS Energy to TEP (5)	1	1	2	2

(1) TEP sells and purchases power with UNS Electric at prevailing market prices.

(2) TEP charges UNS Electric for control area services under a FERC-approved Control Area Services Agreement.

(3) Common costs (information systems, facilities, etc.) are allocated on a cost-causative basis and recorded as revenue by TEP. The method of allocation is deemed reasonable by management and is reviewed by the ACC as part of the rate case process.

(4) SES provides supplemental workforce and meter-reading services to TEP based on related party service agreements. The charges are based on costs of services performed and deemed reasonable by management.

(5) Corporate costs at UNS Energy, such as Fortis management fees, legal fees, and audit fees, are allocated to its subsidiaries using the Massachusetts Formula, an industry accepted method of allocating common costs to affiliated entities. TEP's allocation is approximately 81% of UNS Energy's allocated costs. For the three and six months ended June 30, 2015, these costs included approximately $1 million and $2 million, respectively, in Fortis management fees. For the three and six months of June 30, 2014, these costs included approximately $1 million in merger related costs.

SHARE-BASED COMPENSATION EXPENSE

In January 2015, UNS Energy established a new share-based compensation plan, referred to as the 2015 Share Unit Plan (the Plan), to promote greater alignment of interests between the senior management of UNS Energy and its subsidiaries and the shareholders of Fortis. TEP's allocated share-based compensation expense under the Plan for the three and six months ended June 30, 2015 was less than $1 million. For the three and six months ended June 30, 2014, TEP recognized $1 million of expense under UNS Energy's prior share-based compensation plans.

CONTRIBUTION FROM PARENT

In June 2015, UNS Energy made an equity contribution of $180 million to TEP. TEP used proceeds from the equity contribution to repay the outstanding balances under TEP's revolving credit facilities. The remaining balance of the proceeds is expected to be used to redeem bonds in August 2015 and to provide additional liquidity to TEP.

DIVIDEND PAID

TEP paid no dividends to UNS Energy in the first six months of 2015 and 2014. In July 2015, TEP paid $25 million in dividends to UNS Energy.

NOTE 4. DEBT AND CAPITAL LEASE OBLIGATIONS

We summarize below the significant changes to our debt and capital lease obligations from those reported in our 2014 Annual Report on Form 10-K.

CAPITAL LEASE OBLIGATIONS

Springerville Unit 1 Capital Lease Purchase

In January 2015, upon expiration of the lease term, TEP purchased leased interests comprising 24.8% of Springerville Unit 1, representing 96 megawatts (MW) of capacity, for an aggregate purchase price of $46 million, the appraised value. With the completion of the lease option purchase, TEP owns 49.5% of Springerville Unit 1, or 192 MW of capacity. Furthermore, TEP is obligated to operate the unit for the Third-Party Owners under an existing facility support agreement. The Third-Party Owners are obligated to compensate TEP for their pro rata share of expenses. See Note 5 for additional information regarding the Third-Party Owners.

Springerville Coal Handling Facilities Lease Purchase

In April 2015, upon the expiration of the lease term, TEP purchased an 86.7% undivided ownership interest in the Springerville Coal Handling Facilities at the fixed purchase price of $120 million, bringing its total ownership of the assets to 100%.

In May 2015, Salt River Project Agricultural Improvement and Power District (SRP), the owner of Springerville Unit 4, purchased from TEP a 17.05% undivided interest in the Springerville Coal Handling Facilities for approximately $24 million.

Tri-State Generation and Transmission Association, Inc. (Tri-State), the lessee of Springerville Unit 3, is obligated to either: 1) buy a 17.05% undivided interest in the facilities for approximately $24 million or 2) continue to make payments to TEP for the use of the facilities. Tri-State has until April 2016 to exercise its purchase option. At June 30, 2015, Tri-State's 17.05% undivided interest in the Springerville Coal Handling Facilities is classified as Assets Held for Sale on the Condensed Consolidated Balance Sheets.

ISSUANCES AND REDEMPTIONS

In January 2015, amounts borrowed under the term loan portion of the 2014 Credit Agreement were used to purchase $130 million aggregate principal amount of unsecured Industrial Development Revenue Bonds issued in June 2008 by the Industrial Development Authority (IDA) of Pima County for the benefit of TEP. The multi-modal bonds mature in September 2029. At June 30, 2015, TEP had not canceled or remarketed the repurchased bonds and as a result the bonds were not recorded in Long-Term Debt on the Condensed Consolidated Balance Sheets.

In February 2015, TEP issued and sold $300 million aggregate principal amount of its senior unsecured notes bearing interest at a fixed rate of 3.05% and maturing March 15, 2025. In March 2015, TEP used the net proceeds from the sale to repay $215 million on outstanding borrowings under its credit agreements. In April 2015, the remaining net proceeds were used to pay a portion of the purchase price for its ownership interests in the Springerville Coal Handling Facilities. TEP may redeem the notes prior to December 15, 2024, with a make-whole premium plus accrued interest. On or after December 15, 2024, TEP may redeem the notes at par plus accrued interest. Interest on the notes is payable semi-annually, beginning September 15, 2015, and ending at maturity.

In June 2015, TEP issued irrevocable redemption notices for two series of variable rate tax-exempt bonds with an aggregate principal amount of $79 million. These two series of local-furnishing bonds, issued in 1982 by the IDA of Pima County for the benefit of TEP, will be redeemed at par and are backed by letters of credit (LOCs) issued under TEP’s 2010 Credit Agreement. Upon redemption of the bonds in August 2015, the LOCs will be terminated. At June 30, 2015, the bonds are reflected as Current Maturities of Long-Term Debt on the Condensed Consolidated Balance Sheets.

10

Table of Contents

CREDIT AGREEMENTS

2014 Credit Agreement

In March 2015, net proceeds from the sale of senior unsecured notes were used to repay the outstanding term loan. Per the terms of the agreement, the $130 million term loan could not be reborrowed.

In June 2015, after paying the entire outstanding balance under the revolving credit facility, TEP terminated the credit agreement. As of June 30, 2015, there were no amounts available under the 2014 Credit Agreement revolving credit facility due to the repayment and termination.

2010 Credit Agreement

Interest rates and fees under the 2010 Credit Agreement are based on a pricing grid tied to TEP's credit ratings. With Moody's Investors Service, Inc. (Moody's) increase in TEP's credit rating in February 2015 to A3. The interest rate currently in effect on borrowings decreased to LIBOR plus 1.00% for Eurodollar loans or Alternate Base Rate with no margin for Alternate Base Rate loans. The margin rate currently in effect on the $82 million LOC facility is 1.00%. As of June 30, 2015, there was $200 million available under the revolving credit facility of the 2010 Credit Agreement. As of July 30, 2015, TEP had $200 million available under the 2010 Credit Agreement revolving credit facility.

2010 TEP REIMBURSEMENT AGREEMENT

The 2010 TEP Reimbursement Agreement supports $37 million aggregate principal amount of variable rate tax-exempt bonds and includes fees payable on the aggregate outstanding amount. The rate currently in effect decreased to 0.75% per annum after TEP's credit rating upgrade in February 2015.

COVENANT COMPLIANCE

At June 30, 2015, we were in compliance with the terms of our loan and credit agreements.

NOTE 5. COMMITMENTS, CONTINGENCIES, AND ENVIRONMENTAL MATTERS

COMMITMENTS

In addition to those reported in our 2014 Annual Report on Form 10-K, TEP entered into the following long-term commitments through June 30, 2015:

(in millions)	2015	2016	2017	2018	2019	Thereafter	Total
Fuel, Including Transportation	$1	$2	$2	$2	$2	$46	$55
Purchased Power	—	45					