

TUCSON ELECTRIC POWER CO

Form 10-Q

October 27, 2010

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the quarterly period ended September 30, 2010**  
**OR**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

|                                      |   |
|--------------------------------------|---|
| UniSource Energy Corporation         | Yes <input type="checkbox"/> No <input checked="" type="checkbox"/>                             |
| Tucson Electric Power Company<br>(1) | Yes <input checked="" type="checkbox"/> No <input type="checkbox"/><br><input type="checkbox"/> |

(1) Tucson Electric Power Company is not required to file reports under the Exchange Act. However, Tucson Electric Power Company

has filed all  
Exchange Act  
reports for the  
preceding  
12 months.

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

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

At October 15, 2010, 36,431,763 shares of UniSource Energy Corporation Common Stock, no par value (the only class of Common Stock), were outstanding. At October 15, 2010, 32,139,434 shares of Tucson Electric Power Company's common stock, no par value, were outstanding, all of which were held by UniSource Energy Corporation. This combined Form 10-Q is separately filed by UniSource Energy Corporation and Tucson Electric Power Company. Information contained in this document relating to Tucson Electric Power Company is filed by UniSource Energy Corporation and separately by Tucson Electric Power Company on its own behalf. Tucson Electric Power Company makes no representation as to information relating to UniSource Energy Corporation or its subsidiaries, except as it may relate to Tucson Electric Power Company.

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**DEFINITIONS**

The abbreviations and acronyms used in the 2010 third quarter report on Form 10-Q are defined below:

|                                 |   |
|---------------------------------|---|
| 2008 TEP Rate Order             | A rate order issued by the ACC resulting in a new retail rate structure for TEP, effective December 1, 2008.  |
| ACC                             | Arizona Corporation Commission.   |
| AMT                             | Alternative Minimum Tax.  |
| APS                             | Arizona Public Service Company.   |
| BART                            | Best Available Retrofit Technology  |
| BMGS                            | Black Mountain Generating Station owned by UED.   |
| Btu                             | British thermal unit(s).  |
| Capacity                        | The ability to produce power; the most power a unit can produce or the maximum that can be taken under a contract, measured in MWs.   |
| Common Stock                    | UniSource Energy's common stock, without par value.   |
| Company                         | UniSource Energy Corporation.   |
| Cooling Degree Days             | An index used to measure the impact of weather on energy usage calculated by subtracting 75 from the average of the high and low daily temperatures.                                  |
| DSM                             | Demand side management.   |
| Emission Allowance(s)           | An allowance issued by the Environmental Protection Agency which permits emission of one ton of sulfur dioxide or one ton of nitrogen oxide. These allowances can be bought and sold. |
| Energy                          | The amount of power produced over a given period of time measured in MWh.   |
| EPA                             | Environmental Protection Agency.  |
| FERC                            | Federal Energy Regulatory Commission.   |
| Four Corners                    | Four Corners Generating Station.  |
| GBtu                            | Billion British Thermal Units.  |
| IRS                             | Internal Revenue Service.   |
| kWh                             | Kilowatt-hour(s).   |
| LIBOR                           | London Interbank Offered Rate.  |
| Luna                            | Luna Energy Facility.   |
| Millennium                      | Millennium Energy Holdings, Inc., a wholly-owned subsidiary of UniSource Energy.  |
| MMBtu                           | Million British Thermal Units.  |
| MW                              | Megawatt(s).  |
| MWh                             | Megawatt-hour(s).   |
| Navajo                          | Navajo Generating Station.  |
| O&M                             | Operations and Maintenance Expense.   |
| PGA                             | Purchased Gas Adjuster, a retail rate mechanism designed to recover the cost of gas purchased for retail gas customers.   |
| PPFAC                           | Purchased Power and Fuel Adjustment Clause.   |
| RES                             | Renewable Energy Standard.  |
| Salt River Project              | A public power utility serving more than 900,000 customers in Phoenix, Arizona.   |
| San Juan                        | San Juan Generating Station.  |
| SCR                             | Selective Catalytic Reduction   |
| Springerville                   | Springerville Generating Station.   |
| Springerville Common Facilities | Facilities at Springerville used in common with Springerville Unit 1 and Springerville Unit 2.  |





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|  |   |
|--|---|
| Springerville Common Facilities Leases | Leveraged lease arrangements relating to an undivided one-half interest in certain Springerville Common Facilities.   |
| Springerville Unit 1                   | Unit 1 of the Springerville Generating Station.   |
| Springerville Unit 1 Leases            | Leveraged lease arrangement relating to Springerville Unit 1 and an undivided one-half interest in certain Springerville Common Facilities.   |
| Springerville Unit 2                   | Unit 2 of the Springerville Generating Station.   |
| Springerville Unit 3                   | Unit 3 of the Springerville Generating Station.   |
| Springerville Unit 4                   | Unit 4 of the Springerville Generating Station.   |
| SRP                                    | Salt River Project Agricultural Improvement and Power District.   |
| Sundt                                  | H. Wilson Sundt Generating Station.   |
| Sundt Unit 4                           | Unit 4 of the H. Wilson Sundt Generating Station.   |
| TEP                                    | Tucson Electric Power Company, the principal subsidiary of UniSource Energy.  |
| TEP Credit Agreement                   | Amended and Restated Credit Agreement between TEP and a syndicate of banks, dated as of August 11, 2006. Expires on August 11, 2011.  |
| TEP Revolving Credit Facility          | Revolving credit facility under the TEP Credit Agreement. Expires on August 11, 2011.   |
| TEP Term Loan                          | \$30 million term loan agreement dated as of March 1, 2010. Matures on September 1, 2011.   |
| Therm                                  | A unit of heating value equivalent to 100,000 British thermal units (Btu).  |
| Tri-State                              | Tri-State Generation and Transmission Association.  |
| UED                                    | UniSource Energy Development Company, a wholly-owned subsidiary of UniSource Energy, which engages in developing generation resources and other project development services and related activities.                        |
| UED Credit Agreement                   | Credit agreement between UED and a syndicate of banks, dated as of March 26, 2009, guaranteed by UniSource Energy. Expires on March 24, 2012.   |
| UES                                    | UniSource Energy Services, Inc., an intermediate holding company established to own the operating companies (UNS Gas and UNS Electric).   |
| UniSource Credit Agreement             | Amended and Restated Credit Agreement between UniSource Energy and a syndicate of banks, dated as of August 11, 2006. Expires on August 11, 2011.   |
| UniSource Energy                       | UniSource Energy Corporation.   |
| UNS Electric                           | UNS Electric, Inc., a wholly-owned subsidiary of UES.   |
| UNS Gas                                | UNS Gas, Inc., a wholly-owned subsidiary of UES.  |
| UNS Gas/UNS Electric Revolver          | Revolving credit facility under the Amended and Restated Credit Agreement among UNS Gas and UNS Electric as borrowers, UES as guarantor, and a syndicate of banks, dated as of August 11, 2006. Expires on August 11, 2011. |

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**Report of Independent Registered Public Accounting Firm**

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

We have reviewed the accompanying condensed consolidated balance sheet of UniSource Energy Corporation and its subsidiaries (the Company) as of September 30, 2010, and the related condensed consolidated statements of income for the three-month and nine-month periods ended September 30, 2010 and 2009, the condensed consolidated statement of changes in stockholders' equity and comprehensive income for the nine-month period ended September 30, 2010 and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2010 and 2009. These interim financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole.

Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2009, and the related consolidated statements of income, of cash flows, of capitalization, and of changes in stockholders' equity and comprehensive income for the year then ended (not presented herein), and in our report dated February 25, 2010, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2009, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP  
Phoenix, Arizona  
October 27, 2010

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**Report of Independent Registered Public Accounting Firm**

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

We have reviewed the accompanying condensed consolidated balance sheet of Tucson Electric Power Company and its subsidiaries (the Company) as of September 30, 2010, and the related condensed consolidated statements of income for the three-month and nine-month periods ended September 30, 2010 and 2009, the condensed consolidated statement of changes in stockholder's equity and comprehensive income for the nine-month period ended September 30, 2010, and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2010 and 2009. These interim financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole.

Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2009, and the related consolidated statements of income, of cash flows, of capitalization, and of changes in stockholder's equity and comprehensive income for the year then ended (not present herein), and in our report dated February 25, 2010, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2009, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP  
Phoenix, Arizona  
October 27, 2010

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## PART I FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## UNISOURCE ENERGY CORPORATION

## COMPARATIVE CONDENSED CONSOLIDATED STATEMENTS OF INCOME

| Three Months Ended<br>September 30,<br><b>2010</b> <b>2009</b><br>(Unaudited) |                |  | Nine Months Ended<br>September 30,<br><b>2010</b> <b>2009</b><br>(Unaudited) |                  |
|---|----------------|--|--|------------------|
| -Thousands of Dollars-<br>(Except Per Share Amounts)                          |                |  | -Thousands of Dollars-<br>(Except Per Share Amounts)                         |                  |
|   |                | <b>Operating Revenues</b>  |  |                  |
| \$ 360,028  | \$ 348,938     | Electric Retail Sales  | \$ 824,714   | \$ 817,490       |
| 36,776  | 28,785         | Electric Wholesale Sales   | 100,094  | 92,031           |
|   |                | California Power Exchange (CPX) Provision for<br>Wholesale Refunds | (2,970)  |                  |
| 16,140  | 16,226         | Gas Revenue  | 96,598   | 99,189           |
| 25,824  | 20,290         | Other Revenues   | 76,053   | 55,169           |
| <b>438,768</b>  | <b>414,239</b> | <b>Total Operating Revenues</b>                                    | <b>1,094,489</b>   | <b>1,063,879</b> |
|   |                | <b>Operating Expenses</b>  |  |                  |
| 90,493  | 99,895         | Fuel   | 220,187  | 223,758          |
| 93,889  | 76,207         | Purchased Energy   | 241,151  | 217,121          |
| 3,380   | 2,356          | Transmission   | 8,688  | 7,607            |
| (12,373)  | (15,403)       | Decrease to Reflect PPFAC/PGA Recovery                             | (35,335)   | (5,083)          |
| <b>175,389</b>  | <b>163,055</b> | <b>Total Fuel and Purchased Energy</b>                             | <b>434,691</b>   | <b>443,403</b>   |
| 88,936  | 79,549         | Other Operations and Maintenance                                   | 258,979  | 243,432          |
| 32,450  | 35,246         | Depreciation   | 95,773   | 109,601          |
| 7,177   | 8,433          | Amortization   | 20,797   | 22,280           |
| 11,334  | 11,098         | Taxes Other Than Income Taxes                                      | 35,559   | 35,915           |
| <b>315,286</b>  | <b>297,381</b> | <b>Total Operating Expenses</b>                                    | <b>845,799</b>   | <b>854,631</b>   |
| <b>123,482</b>  | <b>116,858</b> | <b>Operating Income</b>  | <b>248,690</b>   | <b>209,248</b>   |
|   |                | <b>Other Income (Deductions)</b>                                   |  |                  |
| 2,011   | 2,609          | Interest Income  | 5,891  | 9,530            |
| 1,362   | 1,899          | Other Income   | 8,499  | 16,284           |
| (1,621)   | (812)          | Other Expense  | (8,524)  | (2,040)          |
| <b>1,752</b>  | <b>3,696</b>   | <b>Total Other Income (Deductions)</b>                             | <b>5,866</b>   | <b>23,774</b>    |
|   |                | <b>Interest Expense</b>  |  |                  |
| 15,928  | 14,317         | Long-Term Debt   | 46,984   | 43,680           |

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|                  |                  |  |                   |                  |
|------------------|------------------|--|-------------------|------------------|
| <b>11,616</b>    | 12,504           | Capital Leases   | <b>35,124</b>     | 36,762           |
| <b>(1,726)</b>   | 544              | Other Interest Expense, Net of Interest Capitalized              | <b>(1,213)</b>    | 631              |
| <b>25,818</b>    | 27,365           | <b>Total Interest Expense</b>                                    | <b>80,895</b>     | 81,073           |
| <b>99,416</b>    | 93,189           | <b>Income Before Income Taxes</b>                                | <b>173,661</b>    | 151,949          |
| <b>44,533</b>    | 35,543           | Income Tax Expense   | <b>73,266</b>     | 58,110           |
| <b>\$ 54,883</b> | <b>\$ 57,646</b> | <b>Net Income</b>  | <b>\$ 100,395</b> | <b>\$ 93,839</b> |
| <b>36,533</b>    | 35,928           | <b>Weighted-Average Shares of Common Stock Outstanding (000)</b> | <b>36,321</b>     | 35,829           |
| <b>\$ 1.50</b>   | <b>\$ 1.60</b>   | <b>Basic Earnings per Share</b>                                  | <b>\$ 2.76</b>    | <b>\$ 2.62</b>   |
| <b>\$ 1.36</b>   | <b>\$ 1.45</b>   | <b>Diluted Earnings per Share</b>                                | <b>\$ 2.53</b>    | <b>\$ 2.40</b>   |
| <b>\$ 0.39</b>   | <b>\$ 0.29</b>   | <b>Dividends Declared per Share</b>                              | <b>\$ 1.17</b>    | <b>\$ 0.87</b>   |

See Notes to Condensed Consolidated Financial Statements.

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

|  | Nine Months Ended<br>September 30, |                  |
|--|------------------------------------|------------------|
|  | <b>2010</b>                        | <b>2009</b>      |
|  | <b>(Unaudited)</b>                 |                  |
|  | -Thousands of Dollars-             |                  |
| <b>Cash Flows from Operating Activities</b>                    |                                    |                  |
| Cash Receipts from Electric Retail Sales                       | \$ 848,308                         | \$ 858,056       |
| Cash Receipts from Electric Wholesale Sales                    | 138,236                            | 135,006          |
| Cash Receipts from Gas Sales                                   | 124,922                            | 130,765          |
| Cash Receipts from Operating Springerville Units 3 & 4         | 67,593                             | 51,399           |
| Interest Received  | 9,029                              | 12,997           |
| Income Tax Refunds Received                                    | 174                                | 16,961           |
| Performance Deposits Received                                  | 16,200                             | 27,720           |
| Other Cash Receipts  | 15,989                             | 10,086           |
| Purchased Energy Costs Paid                                    | (288,035)                          | (257,414)        |
| Fuel Costs Paid  | (182,703)                          | (227,304)        |
| Payment of Other Operations and Maintenance Costs              | (177,261)                          | (177,101)        |
| Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized | (106,701)                          | (110,271)        |
| Wages Paid, Net of Amounts Capitalized                         | (94,490)                           | (94,217)         |
| Interest Paid, Net of Amounts Capitalized                      | (49,751)                           | (48,312)         |
| Capital Lease Interest Paid                                    | (37,106)                           | (38,050)         |
| Performance Deposit Payments                                   | (17,200)                           | (21,010)         |
| Income Taxes Paid  | (11,246)                           |                  |
| Excess Tax Benefit from Stock Options Exercised                | (1,796)                            | (1,929)          |
| Other Cash Payments  | (4,870)                            | (5,084)          |
| <b>Net Cash Flows Operating Activities</b>                     | <b>249,292</b>                     | <b>262,298</b>   |
| <b>Cash Flows from Investing Activities</b>                    |                                    |                  |
| Capital Expenditures   | (200,183)                          | (236,913)        |
| Purchase of Sundt Unit 4 Lease Asset                           | (51,389)                           |                  |
| Purchase of Springerville Lease Debt                           |                                    | (31,375)         |
| Prepayment Deposit on UED Debt                                 | (3,188)                            | (2,069)          |
| Other Cash Payments  | (820)                              | (866)            |
| Return of Investment in Springerville Lease Debt               | 25,615                             | 12,736           |
| Customer Advance Reimbursement from Citizens                   | 1,254                              |                  |
| Return of Investment from Millennium Energy Businesses         | 423                                | 5,000            |
| Insurance Proceeds for Replacement Assets                      | 1,041                              | 4,928            |
| Other Cash Receipts  | 356                                | 322              |
| <b>Net Cash Flows Investing Activities</b>                     | <b>(226,891)</b>                   | <b>(248,237)</b> |
| <b>Cash Flows from Financing Activities</b>                    |                                    |                  |
| Proceeds from Borrowings Under Revolving Credit Facilities     | 231,000                            | 158,000          |

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|   |                  |                  |
|---|------------------|------------------|
| Proceeds from Issuance of Long-Term Debt                    | <b>39,570</b>    |                  |
| Proceeds from Issuance of Short-Term Debt                   |                  | 30,000           |
| Proceeds from Stock Options Exercised                       | <b>8,896</b>     | 2,021            |
| Excess Tax Benefit from Stock Options Exercised             | <b>1,796</b>     | 1,929            |
| Other Cash Receipts   | <b>6,981</b>     | 4,517            |
| Repayments of Borrowings Under Revolving Credit Facilities  | <b>(199,000)</b> | (140,000)        |
| Payments of Capital Lease Obligations                       | <b>(55,970)</b>  | (24,157)         |
| Common Stock Dividends Paid                                 | <b>(42,326)</b>  | (31,037)         |
| Repayment of Long-Term Debt                                 | <b>(19,445)</b>  | (4,500)          |
| Payment of Debt Issue/Retirement Costs                      | <b>(2,099)</b>   | (963)            |
| Other Cash Payments   | <b>(1,827)</b>   | (1,957)          |
| <b>Net Cash Flows – Financing Activities</b>                | <b>(32,424)</b>  | (6,147)          |
| <b>Net (Decrease) Increase in Cash and Cash Equivalents</b> | <b>(10,023)</b>  | 7,914            |
| <b>Cash and Cash Equivalents, Beginning of Year</b>         | <b>76,922</b>    | 55,172           |
| <b>Cash and Cash Equivalents, End of Period</b>             | <b>\$ 66,899</b> | <b>\$ 63,086</b> |

See Note 16 for supplemental cash flow information.  
See Notes to Condensed Consolidated Financial Statements.



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

|   | September<br>30,<br><b>2010</b> | December 31,<br><b>2009</b> |
|---|---------------------------------|-----------------------------|
|   | <b>(Unaudited)</b>              |                             |
|   | - Thousands of Dollars -        |                             |
| <b>ASSETS</b>   |                                 |                             |
| <b>Utility Plant</b>                                  |                                 |                             |
| Plant in Service                                      | \$ <b>4,412,776</b>             | \$ 4,147,268                |
| Utility Plant under Capital Leases                    | <b>583,374</b>                  | 720,628                     |
| Construction Work in Progress                         | <b>178,642</b>                  | 144,551                     |
| <b>Total Utility Plant</b>                            | <b>5,174,792</b>                | 5,012,447                   |
| Less Accumulated Depreciation and Amortization        | <b>(1,804,302)</b>              | (1,652,296)                 |
| Less Accumulated Amortization of Capital Lease Assets | <b>(456,829)</b>                | (574,437)                   |
| <b>Total Utility Plant Net</b>                        | <b>2,913,661</b>                | 2,785,714                   |
| <b>Investments and Other Property</b>                 |                                 |                             |
| Investments in Lease Debt and Equity                  | <b>104,118</b>                  | 132,168                     |
| Other   | <b>55,939</b>                   | 60,239                      |
| <b>Total Investments and Other Property</b>           | <b>160,057</b>                  | 192,407                     |
| <b>Current Assets</b>                                 |                                 |                             |
| Cash and Cash Equivalents                             | <b>66,899</b>                   | 76,922                      |
| Accounts Receivable - Customer                        | <b>110,014</b>                  | 80,191                      |
| Unbilled Accounts Receivable                          | <b>56,967</b>                   | 53,361                      |
| Allowance for Doubtful Accounts                       | <b>(6,257)</b>                  | (5,977)                     |
| Fuel Inventory  | <b>38,951</b>                   | 48,159                      |
| Materials and Supplies                                | <b>65,150</b>                   | 68,633                      |
| Derivative Instruments                                | <b>6,440</b>                    | 2,653                       |
| Regulatory Assets - Current                           | <b>62,138</b>                   | 41,772                      |
| Deferred Income Taxes - Current                       | <b>54,705</b>                   | 52,355                      |
| Investments in Lease Debt                             | <b>1,473</b>                    |                             |
| Other   | <b>29,888</b>                   | 28,236                      |
| <b>Total Current Assets</b>                           | <b>486,368</b>                  | 446,305                     |
| <b>Regulatory and Other Assets</b>                    |                                 |                             |
| Regulatory Assets - Noncurrent                        | <b>184,097</b>                  | 147,325                     |
| Derivative Instruments                                | <b>9,467</b>                    | 4,498                       |
| Other Assets  | <b>24,618</b>                   | 24,993                      |

|  |                     |              |
|--|---------------------|--------------|
| <b>Total Regulatory and Other Assets</b> | <b>218,182</b>      | 176,816      |
| <b>Total Assets</b>                      | <b>\$ 3,778,268</b> | \$ 3,601,242 |

See Notes to Condensed Consolidated Financial Statements.

**(Continued)**

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

|   | September<br>30,<br><b>2010</b> | December 31,<br><b>2009</b> |
|---|---------------------------------|-----------------------------|
|   | <b>(Unaudited)</b>              |                             |
|   | - Thousands of Dollars -        |                             |
| <b>CAPITALIZATION AND OTHER LIABILITIES</b>         |                                 |                             |
| <b>Capitalization</b>                               |                                 |                             |
| Common Stock Equity                                 | \$ 816,533                      | \$ 750,865                  |
| Capital Lease Obligations                           | 426,881                         | 488,349                     |
| Long-Term Debt                                      | 899,464                         | 1,307,795                   |
| <b>Total Capitalization</b>                         | <b>2,142,878</b>                | <b>2,547,009</b>            |
| <b>Current Liabilities</b>                          |                                 |                             |
| Current Obligations Under Capital Leases            | 60,375                          | 40,441                      |
| Borrowing Under Revolving Credit Facility           | 84,000                          | 35,000                      |
| Current Maturities of Long-Term Debt                | 420,100                         | 12,195                      |
| Accounts Payable Trade                              | 102,363                         | 98,990                      |
| Interest Accrued                                    | 23,327                          | 41,396                      |
| Accrued Taxes Other than Income Taxes               | 55,553                          | 36,698                      |
| Accrued Employee Expenses                           | 26,270                          | 27,545                      |
| Customer Deposits                                   | 28,590                          | 25,978                      |
| Regulatory Liabilities Current                      | 64,880                          | 42,229                      |
| Derivative Instruments                              | 35,864                          | 21,186                      |
| Other   | 16,497                          | 4,038                       |
| <b>Total Current Liabilities</b>                    | <b>917,819</b>                  | <b>385,696</b>              |
| <b>Deferred Credits and Other Liabilities</b>       |                                 |                             |
| Deferred Income Taxes Noncurrent                    | 290,772                         | 227,199                     |
| Regulatory Liabilities Noncurrent                   | 195,755                         | 211,891                     |
| Derivative Instruments                              | 32,132                          | 19,489                      |
| Pension and Other Postretirement Benefits           | 114,093                         | 123,476                     |
| Other   | 84,819                          | 86,482                      |
| <b>Total Deferred Credits and Other Liabilities</b> | <b>717,571</b>                  | <b>668,537</b>              |
| <b>Commitments and Contingencies (Note 6)</b>       |                                 |                             |
| <b>Total Capitalization and Other Liabilities</b>   | <b>\$ 3,778,268</b>             | <b>\$ 3,601,242</b>         |

See Notes to Condensed Consolidated Financial Statements.

(Concluded)



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**UNISOURCE ENERGY CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY AND**  
**COMPREHENSIVE INCOME**

|   | Common<br>Shares<br>Outstanding* | Common<br>Stock   | Accumulated<br>Earnings<br>(Unaudited) | Accumulated<br>Other<br>Comprehensive<br>Loss | Total             |
|---|----------------------------------|-------------------|--|---|-------------------|
|   |                                  |                   | -Thousands of Dollars-                 |   |                   |
| <b>Balances at December 31, 2009</b>  | <b>35,851</b>                    | <b>\$ 696,206</b> | <b>\$ 60,461</b>                       | <b>\$ (5,802)</b>                             | <b>\$ 750,865</b> |
| Comprehensive Income:   |                                  |                   |  |   |                   |
| 2010 Year-to-Date Net Income  |                                  |                   | 100,395                                |   | 100,395           |
| Unrealized Loss on Cash Flow Hedges<br>(net of \$4,950 income taxes)  |                                  |                   |  | (7,550)                                       | (7,550)           |
| Reclassification of Unrealized Losses on<br>Cash Flow Hedges to Net Income<br>(net of \$1,530 income taxes)         |                                  |                   |  | 2,334   | 2,334             |
| Employee Benefit Obligations  |                                  |                   |  |   |                   |
| Amortization of SERP Net Prior Service<br>Cost Included in Net Periodic Benefit Cost<br>(net of \$102 income taxes) |                                  |                   |  | 156   | 156               |
| Total Comprehensive Income  |                                  |                   |  |   | 95,335            |
| Dividends Declared  |                                  |                   | (42,646)                               |   | (42,646)          |
| Shares Issued under Deferred Compensation<br>Plans  | 18                               | 587               |  |   | 587               |
| Shares Issued under Stock Compensation<br>Plans -<br>(net of shares redeemed for taxes)                             | 508                              | 8,507             |  |   | 8,507             |
| Tax Benefit Realized from Share-Based<br>Compensation Plans   |                                  | 1,796             |  |   | 1,796             |
| Other Share-Based Compensation  |                                  | 2,089             |  |   | 2,089             |
| <b>Balances at September 30, 2010</b>   | <b>36,377</b>                    | <b>\$ 709,185</b> | <b>\$ 118,210</b>                      | <b>\$ (10,862)</b>                            | <b>\$ 816,533</b> |

\* UniSource  
Energy has  
75 million

authorized  
shares of  
Common Stock.

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****TUCSON ELECTRIC POWER COMPANY  
COMPARATIVE CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

| Three Months Ended               |                |   | Nine Months Ended |                |
|----------------------------------|----------------|---|-------------------|----------------|
| September 30,                    |                |   | September 30,     |                |
| 2010                             | 2009           |   | 2010              | 2009           |
| (Unaudited)                      |                |   | (Unaudited)       |                |
| -Thousands of                    |                |   | -Thousands of     |                |
| Dollars-                         |                |   | Dollars-          |                |
| <b>Operating Revenues</b>        |                |   |                   |                |
| \$ 300,348                       | \$ 297,418     | Electric Retail Sales   | \$ 685,322        | \$ 675,190     |
| 26,669                           | 38,018         | Electric Wholesale Sales  | 94,694            | 107,762        |
|                                  |                | California Power Exchange (CPX) Provision for Wholesale Refunds | (2,970)           |                |
| 27,559                           | 21,753         | Other Revenues  | 81,066            | 59,055         |
| <b>354,576</b>                   | <b>357,189</b> | <b>Total Operating Revenues</b>                                 | <b>858,112</b>    | <b>842,007</b> |
| <b>Operating Expenses</b>        |                |   |                   |                |
| 85,793                           | 92,330         | Fuel  | 210,838           | 208,808        |
| 47,909                           | 52,999         | Purchased Power   | 103,766           | 112,416        |
| 972                              | 632            | Transmission  | 2,818             | 2,439          |
| (13,362)                         | (12,895)       | Decrease to Reflect PPFAC Recovery                              | (24,098)          | (16,898)       |
| <b>121,312</b>                   | <b>133,066</b> | <b>Total Fuel and Purchased Energy</b>                          | <b>293,324</b>    | <b>306,765</b> |
| 76,277                           | 69,232         | Other Operations and Maintenance                                | 224,441           | 213,069        |
| 25,190                           | 28,073         | Depreciation  | 74,143            | 88,605         |
| 8,153                            | 9,646          | Amortization  | 23,963            | 25,934         |
| 9,271                            | 9,117          | Taxes Other Than Income Taxes                                   | 29,049            | 29,413         |
| <b>240,203</b>                   | <b>249,134</b> | <b>Total Operating Expenses</b>                                 | <b>644,920</b>    | <b>663,786</b> |
| <b>114,373</b>                   | <b>108,055</b> | <b>Operating Income</b>   | <b>213,192</b>    | <b>178,221</b> |
| <b>Other Income (Deductions)</b> |                |   |                   |                |
| 1,725                            | 2,367          | Interest Income   | 5,111             | 9,176          |
| 2,014                            | 1,686          | Other Income  | 4,347             | 9,671          |
| (826)                            | (702)          | Other Expense   | (2,425)           | (1,616)        |
| <b>2,913</b>                     | <b>3,351</b>   | <b>Total Other Income (Deductions)</b>                          | <b>7,033</b>      | <b>17,231</b>  |
| <b>Interest Expense</b>          |                |   |                   |                |
| 10,223                           | 8,829          | Long-Term Debt  | 30,255            | 27,232         |
| 11,614                           | 12,502         | Capital Leases  | 35,118            | 36,753         |
| (1,683)                          | 159            | Other Interest Expense, Net of Interest Capitalized             | (1,641)           | (289)          |
| <b>20,154</b>                    | <b>21,490</b>  | <b>Total Interest Expense</b>                                   | <b>63,732</b>     | <b>63,696</b>  |

|                  |                  |                                   |                  |                  |
|------------------|------------------|-----------------------------------|------------------|------------------|
| <b>97,132</b>    | 89,916           | <b>Income Before Income Taxes</b> | <b>156,493</b>   | 131,756          |
| <b>38,139</b>    | 34,639           | Income Tax Expense                | <b>59,514</b>    | 50,527           |
| <b>\$ 58,993</b> | <b>\$ 55,277</b> | <b>Net Income</b>                 | <b>\$ 96,979</b> | <b>\$ 81,229</b> |

See Notes to Condensed Consolidated Financial Statements.



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

|  | Nine Months Ended<br>September 30, |                  |
|--|------------------------------------|------------------|
|  | <b>2010</b>                        | <b>2009</b>      |
|  | <b>(Unaudited)</b>                 |                  |
|  | -Thousands of Dollars-             |                  |
| <b>Cash Flows from Operating Activities</b>                    |                                    |                  |
| Cash Receipts from Electric Retail Sales                       | \$ 704,027                         | \$ 701,988       |
| Cash Receipts from Electric Wholesale Sales                    | 140,207                            | 152,897          |
| Cash Receipts from Operating Springerville Units 3 & 4         | 67,593                             | 51,399           |
| Reimbursement of Affiliate Charges                             | 13,781                             | 19,625           |
| Interest Received  | 8,986                              | 12,759           |
| Performance Deposits Received                                  | 5,040                              | 6,073            |
| Income Tax Refunds Received                                    | 3,369                              | 10,423           |
| Other Cash Receipts  | 8,270                              | 11,774           |
| Fuel Costs Paid  | (173,796)                          | (212,389)        |
| Payment of Other Operations and Maintenance Costs              | (166,487)                          | (167,919)        |
| Purchased Power Costs Paid                                     | (143,793)                          | (141,700)        |
| Capital Lease Interest Paid                                    | (37,099)                           | (38,042)         |
| Wages Paid, Net of Amounts Capitalized                         | (76,637)                           | (75,162)         |
| Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized | (88,390)                           | (81,716)         |
| Interest Paid, Net of Amounts Capitalized                      | (28,841)                           | (27,260)         |
| Performance Deposit Payments                                   | (5,040)                            | (13,750)         |
| Income Taxes Paid  | (14,865)                           | (8,636)          |
| Other Cash Payments  | (2,487)                            | (2,890)          |
| <b>Net Cash Flows    Operating Activities</b>                  | <b>213,838</b>                     | <b>197,474</b>   |
| <b>Cash Flows from Investing Activities</b>                    |                                    |                  |
| Capital Expenditures   | (166,338)                          | (194,777)        |
| Purchase of Sundt Unit 4 Lease Asset                           | (51,389)                           |                  |
| Purchase of Springerville Lease Debt                           |                                    | (31,375)         |
| Other Cash Payments  | (1)                                | (409)            |
| Return of Investment in Springerville Lease Debt               | 25,615                             | 12,736           |
| Insurance Proceeds for Replacement Assets                      | 1,041                              | 4,928            |
| Other Cash Receipts  | 347                                |                  |
| <b>Net Cash Flows    Investing Activities</b>                  | <b>(190,725)</b>                   | <b>(208,897)</b> |
| <b>Cash Flows from Financing Activities</b>                    |                                    |                  |
| Proceeds from Borrowings Under Revolving Credit Facility       | 177,000                            | 126,000          |
| Proceeds from Issuance of Long-Term Debt                       | 30,000                             |                  |
| Equity Investment from UniSource Energy                        | 15,000                             | 30,000           |
| Other Cash Receipts  | 1,831                              | 2,246            |
| Repayments of Borrowings Under Revolving Credit Facility       | (157,000)                          | (111,000)        |

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|   |                  |                  |
|---|------------------|------------------|
| Payments of Capital Lease Obligations                       | <b>(55,889)</b>  | (24,091)         |
| Dividends Paid to UniSource Energy                          | <b>(30,000)</b>  | (30,000)         |
| Payment of Debt Issue/Retirement Costs                      | <b>(1,505)</b>   | (24)             |
| Other Cash Payments   | <b>(1,177)</b>   | (1,282)          |
| <b>Net Cash Flows Financing Activities</b>                  | <b>(21,740)</b>  | (8,151)          |
| <b>Net Increase (Decrease) in Cash and Cash Equivalents</b> | <b>1,373</b>     | (19,574)         |
| <b>Cash and Cash Equivalents, Beginning of Year</b>         | <b>22,418</b>    | 33,275           |
| <b>Cash and Cash Equivalents, End of Period</b>             | <b>\$ 23,791</b> | <b>\$ 13,701</b> |

See Note 16 for supplemental cash flow information.  
See Notes to Condensed Consolidated Financial Statements.

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

|   | September<br>30,<br><b>2010</b> | December 31,<br><b>2009</b> |
|---|---------------------------------|-----------------------------|
|   | <b>(Unaudited)</b>              |                             |
|   | - Thousands of Dollars -        |                             |
| <b>ASSETS</b>   |                                 |                             |
| <b>Utility Plant</b>                                  |                                 |                             |
| Plant in Service                                      | \$ <b>3,826,705</b>             | \$ 3,584,308                |
| Utility Plant under Capital Leases                    | <b>582,669</b>                  | 719,922                     |
| Construction Work in Progress                         | <b>138,884</b>                  | 113,390                     |
| <b>Total Utility Plant</b>                            | <b>4,548,258</b>                | 4,417,620                   |
| Less Accumulated Depreciation and Amortization        | <b>(1,717,762)</b>              | (1,582,442)                 |
| Less Accumulated Amortization of Capital Lease Assets | <b>(456,177)</b>                | (573,853)                   |
| <b>Total Utility Plant Net</b>                        | <b>2,374,319</b>                | 2,261,325                   |
| <b>Investments and Other Property</b>                 |                                 |                             |
| Investments in Lease Debt and Equity                  | <b>104,118</b>                  | 132,168                     |
| Other   | <b>33,143</b>                   | 31,813                      |
| <b>Total Investments and Other Property</b>           | <b>137,261</b>                  | 163,981                     |
| <b>Current Assets</b>                                 |                                 |                             |
| Cash and Cash Equivalents                             | <b>23,791</b>                   | 22,418                      |
| Accounts Receivable - Customer                        | <b>92,197</b>                   | 62,508                      |
| Unbilled Accounts Receivable                          | <b>45,758</b>                   | 32,368                      |
| Allowance for Doubtful Accounts                       | <b>(4,285)</b>                  | (3,806)                     |
| Accounts Receivable - Due from Affiliates             | <b>3,344</b>                    | 5,218                       |
| Fuel Inventory  | <b>38,941</b>                   | 48,149                      |
| Materials and Supplies                                | <b>54,031</b>                   | 56,712                      |
| Derivative Instruments                                | <b>2,596</b>                    | 5,043                       |
| Regulatory Assets - Current                           | <b>33,983</b>                   | 27,026                      |
| Deferred Income Taxes - Current                       | <b>55,323</b>                   | 50,789                      |
| Investments in Lease Debt                             | <b>1,473</b>                    |                             |
| Other   | <b>21,390</b>                   | 24,362                      |
| <b>Total Current Assets</b>                           | <b>368,542</b>                  | 330,787                     |
| <b>Regulatory and Other Assets</b>                    |                                 |                             |
| Regulatory Assets - Noncurrent                        | <b>170,287</b>                  | 137,147                     |
| Derivative Instruments                                | <b>1,971</b>                    | 1,075                       |
| Other Assets  | <b>20,477</b>                   | 19,984                      |

|  |                     |              |
|--|---------------------|--------------|
| <b>Total Regulatory and Other Assets</b> | <b>192,735</b>      | 158,206      |
| <b>Total Assets</b>                      | <b>\$ 3,072,857</b> | \$ 2,914,299 |

See Notes to Condensed Consolidated Financial Statements.

**(Continued)**

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

|   | September<br>30,<br><b>2010</b> | December 31,<br><b>2009</b> |
|---|---------------------------------|-----------------------------|
|   | <b>(Unaudited)</b>              |                             |
|   | - Thousands of Dollars -        |                             |
| <b>CAPITALIZATION AND OTHER LIABILITIES</b>         |                                 |                             |
| <b>Capitalization</b>                               |                                 |                             |
| Common Stock Equity                                 | \$ 720,063                      | \$ 643,144                  |
| Capital Lease Obligations                           | 426,881                         | 488,311                     |
| Long-Term Debt                                      | 575,015                         | 903,615                     |
| <b>Total Capitalization</b>                         | <b>1,721,959</b>                | <b>2,035,070</b>            |
| <b>Current Liabilities</b>                          |                                 |                             |
| Current Maturities of Long-Term Debt                | 358,600                         |                             |
| Current Obligations Under Capital Leases            | 60,309                          | 40,332                      |
| Borrowing Under Revolving Credit Facility           | 55,000                          | 35,000                      |
| Accounts Payable Trade                              | 81,291                          | 71,328                      |
| Accounts Payable Due to Affiliates                  | 3,068                           | 3,694                       |
| Interest Accrued                                    | 20,954                          | 33,970                      |
| Accrued Taxes Other than Income Taxes               | 46,176                          | 28,404                      |
| Accrued Employee Expenses                           | 23,129                          | 24,409                      |
| Customer Deposits                                   | 20,138                          | 18,125                      |
| Derivative Instruments                              | 8,188                           | 9,434                       |
| Regulatory Liabilities Current                      | 57,042                          | 26,639                      |
| Other   | 5,199                           | 1,445                       |
| <b>Total Current Liabilities</b>                    | <b>739,094</b>                  | <b>292,780</b>              |
| <b>Deferred Credits and Other Liabilities</b>       |                                 |                             |
| Deferred Income Taxes Noncurrent                    | 268,385                         | 217,316                     |
| Regulatory Liabilities Noncurrent                   | 161,555                         | 179,478                     |
| Derivative Instruments                              | 15,362                          | 11,195                      |
| Pension and Other Postretirement Benefits           | 108,437                         | 116,991                     |
| Other   | 58,065                          | 61,469                      |
| <b>Total Deferred Credits and Other Liabilities</b> | <b>611,804</b>                  | <b>586,449</b>              |
| <b>Commitments and Contingencies (Note 6)</b>       |                                 |                             |
| <b>Total Capitalization and Other Liabilities</b>   | <b>\$ 3,072,857</b>             | <b>\$ 2,914,299</b>         |

See Notes to Condensed Consolidated Financial Statements.

**(Concluded)**

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

|   | Common<br>Stock          | Capital<br>Stock<br>Expense | Accumulated<br>Deficit<br>(Unaudited) | Accumulated<br>Other<br>Comprehensive<br>Loss | Total             |
|---|--------------------------|-----------------------------|---------------------------------------|---|-------------------|
|   | - Thousands of Dollars - |                             |                                       |   |                   |
| <b>Balances at December 31, 2009</b>  | <b>\$ 843,971</b>        | <b>\$ (6,357)</b>           | <b>\$ (188,668)</b>                   | <b>\$ (5,802)</b>                             | <b>\$ 643,144</b> |
| Comprehensive Income:   |                          |                             |                                       |   |                   |
| 2010 Year-to-Date Net Income  |                          |                             | 96,979                                |   | 96,979            |
| Unrealized Loss on Cash Flow Hedges<br>(net of \$4,950 income taxes)  |                          |                             |                                       | (7,550)                                       | (7,550)           |
| Reclassification of Unrealized Losses on<br>Cash Flow Hedges to Net Income<br>(net of \$1,530 income taxes)   |                          |                             |                                       | 2,334   | 2,334             |
| Employee Benefit Obligations<br>Amortization of SERP Net Prior Service<br>Cost Included in Net Periodic Benefit Cost<br>(net of \$102 income taxes) |                          |                             |                                       | 156   | 156               |
| Total Comprehensive Income  |                          |                             |                                       |   | 91,919            |
| Capital Contribution from UniSource<br>Energy   | 15,000                   |                             |                                       |   | 15,000            |
| Dividends Paid  |                          |                             | (30,000)                              |   | (30,000)          |
| <b>Balances at September 30, 2010</b>   | <b>\$ 858,971</b>        | <b>\$ (6,357)</b>           | <b>\$ (121,689)</b>                   | <b>\$ (10,862)</b>                            | <b>\$ 720,063</b> |

See Notes to Condensed Consolidated Financial Statements.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Unaudited**

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

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

TEP, a regulated public utility, is UniSource Energy's largest operating subsidiary and represented approximately 81% of UniSource Energy's assets as of September 30, 2010. TEP generates, transmits and distributes electricity to approximately 402,000 retail electric customers in a 1,155 square mile area in Southern Arizona. TEP also sells electricity to other utilities and power marketing entities primarily located in the Western U.S. In addition, TEP operates Springerville Unit 3 on behalf of Tri-State Generation and Transmission Association, Inc. (Tri-State) and, Springerville Unit 4 on behalf of Salt River Project Agricultural Improvement and Power District (SRP).

UES holds the common stock of UNS Gas, Inc. (UNS Gas) and UNS Electric, Inc. (UNS Electric). UNS Gas is a gas distribution company with 145,000 retail customers in Mohave, Yavapai, Coconino, and Navajo counties in Northern Arizona, as well as Santa Cruz county in Southeast Arizona. UNS Electric is an electric transmission and distribution company with approximately 91,000 retail customers in Mohave and Santa Cruz counties. UED owns the Black Mountain Generating Station (BMGS), a natural gas-fired combustion turbine in Northern Arizona that, through a power sale agreement, provides electricity to UNS Electric.

Millennium holds investments in unregulated businesses that represent less than 1% of UniSource Energy's assets as of September 30, 2010. Millennium is in the process of exiting its remaining investments which may yield gains or losses. At September 30, 2010, Millennium's key assets include: a \$15 million note receivable related to the 2009 sale of Sabinas, \$7 million of investments related to various energy technology projects and \$3 million in cash. See Note 13 for additional information.

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

The accompanying quarterly financial statements of UniSource Energy and TEP are unaudited but reflect all normal recurring accruals and other adjustments which we believe are necessary for a fair presentation of the results for the interim periods presented. These financial statements are presented in accordance with the Securities and Exchange Commission's (SEC) interim reporting requirements which do not include all the disclosures required by accounting principles generally accepted in the United States of America (GAAP) for audited annual financial statements. The year-end condensed balance sheet data was derived from audited financial statements, but does not include disclosures required by GAAP for audited annual financial statements. This quarterly report should be reviewed in conjunction with UniSource Energy and TEP's 2009 Annual Report on Form 10-K, and quarterly reports on Form 10-Q for the quarters ended March 31 and June 30, 2010.

Weather, among other factors, causes seasonal fluctuations in TEP, UNS Gas and UNS Electric's sales; therefore, quarterly results are not indicative of annual operating results.

In an effort to more closely match GAAP taxonomies in extensible business reporting language, more commonly known as XBRL, UniSource Energy and TEP made the following balance sheet presentation changes from previously issued financial statements to conform to the current presentation:

Accounts Receivable - Retail and Other, and Accounts Receivable Wholesale are no longer shown separately, but, instead are reported as Accounts Receivable - Customer or Accounts Receivable - Non-customers reported in Other Assets;

Separately report Fuel Inventory which was previously combined with Materials Inventory;

Rather than being shown separately, all regulatory balances are reported in either Regulatory Assets - Current, Regulatory Assets - Noncurrent, Regulatory Liabilities - Current, or Regulatory Liabilities - Noncurrent;

Combined Accounts Payable and Accounts Payable - Purchased Power to report in the aggregate as Accounts Payable - Trade; and



Customer Advances for Construction are no longer shown separately; but, instead, are reported as Other within Deferred Credits and Other Liabilities.

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited****NOTE 2. REGULATORY MATTERS****ACCOUNTING FOR RATE REGULATION**

The Arizona Corporation Commission (ACC) and the Federal Energy Regulatory Commission (FERC) regulate portions of TEP, UNS Gas, and UNS Electric (the three utilities) utility accounting practices and rates. The ACC has authority over certain rates charged to retail customers, the issuance of securities, and transactions with affiliated parties. The FERC regulates rates for wholesale power sales and interstate transmission services.

**TEP RATES AND REGULATION**

The following table summarizes TEP's regulatory assets and liabilities:

|   | <b>September<br/>30,<br/>2010</b> | December 31,<br>2009 |
|---|-----------------------------------|----------------------|
|   | -Millions of Dollars-             |                      |
| <b>Regulatory Assets Current</b>  |                                   |                      |
| Property Tax Deferrals  | \$ 17                             | \$ 16                |
| Derivative Instruments  | 6                                 | 4                    |
| Deregulation Costs  | 4                                 | 4                    |
| Demand Side Management (DSM) Assets   | 4                                 |                      |
| Other Current Regulatory Assets   | 3                                 | 3                    |
| <b>Total Regulatory Assets Current</b>  | <b>34</b>                         | <b>27</b>            |
| <b>Regulatory Assets Noncurrent</b>   |                                   |                      |
| Pension and Other Postretirement Benefits   | 78                                | 80                   |
| Income Taxes Recoverable through Future Revenues  | 18                                | 18                   |
| Final Mine Reclamation Costs  | 10                                | 9                    |
| PPFAC Under-Recovered Purchased Energy Costs  | 44                                |                      |
| PPFAC Over-Recovered Purchased Energy Costs, Fixed CTC Revenue to be Refunded                           | (3)                               |                      |
| San Juan Coal Contract Amendment  | 6                                 | 7                    |
| Retiree Health Care Costs   | 6                                 | 6                    |
| Unamortized Loss on Reacquired Debt   | 5                                 | 4                    |
| Deregulation Costs  | 4                                 | 7                    |
| Derivative Instruments  | 2                                 | 5                    |
| Other Regulatory Assets   |                                   | 1                    |
| <b>Total Regulatory Assets Noncurrent</b>   | <b>170</b>                        | <b>137</b>           |
| <b>Regulatory Liabilities Current</b>   |                                   |                      |
| PPFAC Over-Recovered Purchased Energy Costs, Fixed CTC Revenue to be Refunded Within the Next 12 Months | (35)                              | (9)                  |
| Renewable Energy Standards (RES) Tariff   | (20)                              | (17)                 |
| Other Current Regulatory Liabilities  | (2)                               | (1)                  |
| <b>Total Regulatory Liabilities Current</b>   | <b>(57)</b>                       | <b>(27)</b>          |

|   |                |           |              |
|---|----------------|-----------|--------------|
| <b>Regulatory Liabilities</b>   |                |           |              |
| <b>Noncurrent</b>   |                |           |              |
| Net Cost of Removal for Interim Retirements                                   | (160)          |           | (162)        |
| Derivative Instruments  | (2)            |           |              |
| PPFAC Under-Recovered Purchased Energy Costs                                  |                |           | 20           |
| PPFAC Over-Recovered Purchased Energy Costs, Fixed CTC Revenue to be Refunded |                |           | (37)         |
| <b>Total Regulatory Liabilities</b>   | <b>(162)</b>   |           | <b>(179)</b> |
| <b>Noncurrent</b>   |                |           |              |
| <b>Total Net Regulatory Assets (Liabilities)</b>                              | <b>\$ (15)</b> | <b>\$</b> | <b>(42)</b>  |

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited  
TEP Purchased Power and Fuel Adjustment Clause (PPFAC)**

TEP is allowed recovery of fuel, transmission, and purchased power costs, including demand charges and the prudent costs of contracts for hedging fuel and purchased power costs. The PPFAC mechanism provides for the annual adjustment of retail rates to reflect variations in retail fuel and purchased power costs from the base power supply rate currently included in base rates of approximately 2.9 cents per kWh. The current PPFAC rate of 0.09 cents per kWh, effective April 2010, includes a forward component credit of (0.08) cents and a true-up component of 0.17 cents. TEP offsets the forward and true-up components of the PPFAC with Fixed Competition Transition Charge (CTC) revenue to be refunded, resulting in a PPFAC charge of zero to customers until the CTC is fully credited. For the year ended March 2010, TEP had a PPFAC rate of 0.18 cents per kWh. TEP had no PPFAC rate in the first quarter of 2009. The following table shows the changes in the deferred purchased energy regulatory asset (liability) and the impacts on revenue and expense for the nine months ended September 30, 2010:

|   | Balance at            |              | Nine Months Ended |           |
|---|-----------------------|--------------|-------------------|-----------|
|   | September             | December 31, | Impact on         | Impact on |
|   | 30,                   | 2009         | Revenue           | Expense   |
|   | 2010                  |              |                   |           |
|   | -Millions of Dollars- |              |                   |           |
| <b>Fixed CTC Revenue to be Refunded Within the Next 12 Months; Included in Regulatory Liabilities Current</b> | \$ (35)               | \$ (9)       | \$ (26)           | \$        |
| Under-Recovered Purchased Energy Costs Regulatory Basis As Billed to Customers                                | \$ 57                 | \$ 29        |                   | 28        |
| Reduction in Under-Recovered Purchased Energy Costs As Estimated in Accrued Unbilled Revenues                 | (13)                  | (9)          |                   | (4)       |
| Fixed CTC Revenue to be Refunded  | (3)                   | (37)         | 34                |           |
| <b>Total Included in Regulatory Assets (Liabilities) Noncurrent</b>   | \$ 41                 | \$ (17)      |                   |           |
| <b>Increase in Retail Revenue to reflect Amortization of Fixed CTC Revenue</b>                                |                       |              | \$ 8              |           |
| <b>Decrease in Fuel and Purchased Energy Expense to reflect PPFAC Recovery</b>                                |                       |              |                   | \$ 24     |

For the nine months ended September 2009, the increase in Retail Revenue to reflect Amortization of Fixed CTC Revenue was \$8 million and the decrease in Fuel and Purchased Energy Expense to reflect PPFAC Recovery was \$17 million.



**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited  
UNS GAS RATES AND REGULATION**

UNS Gas has the following Regulatory Assets and Liabilities:

|  | <b>September<br/>30,<br/>2010</b> | December 31,<br>2009 |
|--|-----------------------------------|----------------------|
|  | -Millions of Dollars-             |                      |
| <b>Current Assets</b>                            |                                   |                      |
| Derivative Instruments                           | \$ 10                             | \$ 5                 |
| <b>Other Regulatory Assets</b>                   |                                   |                      |
| Pension Obligations                              | 2                                 | 2                    |
| Derivative Instruments                           | 3                                 | 3                    |
| Other Regulatory Assets                          | 1                                 | 1                    |
| <b>Regulatory Liabilities</b>                    |                                   |                      |
| PGA Over-Recovered Purchased Energy Costs        | (7)                               | (10)                 |
| Net Cost of Removal for Interim Retirements      | (22)                              | (21)                 |
| <b>Total Net Regulatory Assets (Liabilities)</b> | <b>\$ (13)</b>                    | <b>\$ (20)</b>       |

**2008 General Rate Case Filing**

In November 2008, UNS Gas filed a general rate case (on a cost of service basis) with the ACC requesting a total rate increase of 6% to cover a revenue deficiency of \$10 million. Effective April 2010, the ACC approved a rate increase of 2% (\$3 million), including an 8% return on original cost rate base. The rate increase is intended to cover the costs of providing service.

**Purchased Gas Adjuster (PGA) Mechanism**

UNS Gas retail rates include a PGA mechanism intended to address the volatility of natural gas prices and allow UNS Gas to recover its actual commodity costs, including transportation, through a price adjuster. All purchased gas commodity costs, including transportation, increase the PGA bank, a balancing account. UNS Gas recovers these costs or returns amounts over-collected from/to ratepayers through a PGA mechanism which is reset monthly and for 2010 ranged from 75.83 cents per therm to 72.33 cents per therm. In 2009, the PGA rate ranged from 88.70 cents per therm to 76.56 cents per therm. In October 2009, the ACC approved an 8 cent per therm PGA surcredit, effective November 2009 through October 2010. Effective November 2010, UNS Gas will not have a PGA surcredit or surcharge until Over-Recovered Purchased Energy Costs exceed predetermined thresholds. See table above for the balance of Over-Recovered Purchased Energy Costs.

**UNS ELECTRIC RATES AND REGULATION**

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

|   | <b>September<br/>30,<br/>2010</b> | December 31,<br>2009 |
|---|-----------------------------------|----------------------|
|   | -Millions of Dollars-             |                      |
| <b>Current Regulatory Assets</b>            |                                   |                      |
| Derivative Instruments                      | \$ 14                             | \$ 9                 |
| PPFAC Under-Recovered Purchased Power Costs | 3                                 |                      |
| <b>Other Regulatory Assets</b>              |                                   |                      |
| Derivative Instruments                      | 6                                 | 2                    |
| Pension Assets                              | 2                                 | 2                    |
| Other                                       |                                   | 1                    |

**Current Regulatory Liabilities**

PPFAC Over-Recovered Purchased Power Costs (5)

**Other Regulatory Liabilities**

Net Cost of Removal for Interim Retirements (13) (12)

**Total Net Regulatory Assets (Liabilities)** \$ 12 \$ (3)

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited  
2009 General Rate Case Filing**

In April 2009, UNS Electric filed a general rate case with the ACC (on a cost of service basis) requesting a rate increase of 7% to cover a revenue deficiency of \$14 million. In September 2010, the ACC approved a rate increase of 4% (\$7 million), including an 8% return on original cost rate base, effective October 1, 2010. The rate increase is intended to cover the costs of providing service. The ACC approved new depreciation rates effective October 1, 2010, resulting in an expected \$1 million annual reduction of depreciation expense.

The ACC rate order also authorized the purchase by UNS Electric of BMGS from UED at its net book value of approximately \$62 million. Upon purchase of this facility, subject to FERC approval, BMGS will be placed into rate base through a revenue-neutral rate reclassification of approximately 0.7 cents per kWh from base power supply rate to the non-fuel base rate.

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

The PPFAC allows recovery of fuel and purchased power costs, including demand charges and the prudent costs of contracts for hedging fuel and purchased power costs. In April 2010, UNS Electric filed an annual PPFAC recommendation with the ACC to have a (0.28) cent PPFAC surcredit for twelve months. This includes a forward component credit of (0.42) cents and a true-up component of 0.14 cents. The surcredit was effective starting June 2010. In September 2010, as part of the general rate case the ACC updated and approved a 0.08 cent PPFAC surcharge and a base power supply rate of approximately 6.77 cents per kWh which includes an updated forward component credit of (0.06) cents and a true-up component of 0.14 cents. The surcharge is effective October 2010 through May 2011.

**RES and DSM**

The ACC allows TEP and UNS Electric to include a RES tariff on customer bills to recover qualified expenditures related to renewable energy projects. TEP and UNS Electric are required to file a five-year implementation plan with the ACC, and annually seek approval for the upcoming year's RES funding amount. For 2010, the ACC approved collections through the RES tariff of \$32 million for TEP and \$8 million for UNS Electric. In 2010, the ACC approved annual collections through the DSM tariffs of \$14 million for TEP, \$2 million for UNS Electric and \$1 million for UNS Gas.

In May 2010, the ACC approved a funding mechanism for approximately \$14 million of TEP owned renewable energy projects. The mechanism allows TEP to use RES funds to recover operating costs, depreciation, property taxes and provide TEP with a return on its investment until these costs could be recovered as part of TEP's base rates. TEP expects these projects to be completed by the end of 2010 and cost recovery of the investment to begin through the RES tariff in January 2011.

In July 2010, TEP filed its 2011 RES implementation plan with the ACC. The plan includes a proposal for TEP to invest \$28 million in TEP owned solar projects per year. These company-owned solar projects would be installed between 2011 and 2014. The plan allows TEP to use RES funds to recover operating costs, depreciation, property taxes and provides TEP with a return on its investment until these costs could be recovered as part of TEP's base rates. In September 2010, the ACC approved a proposal for UNS Electric to invest approximately \$5 million in UNS Electric owned solar projects per year between 2011 and 2014. The plan allows UNS Electric to use RES funds to recover operating costs, depreciation, property taxes and provides UNS Electric with a return on its investment until these costs could be recovered as part of UNS Electric's base rates.



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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited  
Renewable Energy Purchase Power Agreements**

In 2009, TEP entered into three 20-year long-term purchase power agreements with companies developing renewable energy generation facilities. The ACC approved the agreements in April 2010. The facilities are expected to begin commercial operation during 2011 or 2012. TEP is required to purchase the full output of each facility for 20 years. Expected capacities range from 1.4 MW to 25 MW. TEP is only obligated to pay for actual energy delivered. There are no minimum payment obligations under these contracts. TEP is authorized to recover a portion of the cost of renewable energy through the PPFAC with the balance of costs recoverable through the RES tariff.

In 2010, TEP entered into similar long-term renewable energy contracts for approximately 96 MW of solar energy, 50 MW of wind energy and 2.2 MW of landfill gas. The ACC approved these agreements in August 2010. These facilities are also expected to begin commercial operation during 2011 and 2012.

In 2009, UNS Electric entered into a 20-year long-term purchase power agreement with a company developing a renewable energy generation facility. The agreement received ACC approval in April 2010. The facility is expected to begin commercial operation in 2011. UNS Electric is required to purchase the full output of the facility for 20 years. The facility has an expected minimum capacity of 7 MW. UNS Electric is only obligated to pay for actual energy delivered. There is no minimum payment obligation under this contract. UNS Electric is authorized to recover a portion of the cost of renewable energy through the PPFAC with the balance of cost recovery through the RES surcharge.

**NOTE 3. BUSINESS SEGMENTS**

Based on the way we organize our operations and evaluate performance, we have three reportable segments:

- (1) TEP, a vertically integrated electric utility business, UniSource Energy's largest subsidiary;
- (2) UNS Gas, a regulated gas distribution utility business; and
- (3) UNS Electric, a regulated electric distribution utility business.

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

The UniSource Energy and UES holding companies, Millennium, and UED are included in Other. Reconciling adjustments consist of the elimination of intersegment revenues which were due to the following transactions and are eliminated in consolidation:

|  |  | Reportable Segments   |             |                 |           |           |           |
|--|--|-----------------------|-------------|-----------------|-----------|-----------|-----------|
|  |  | TEP                   | UNS<br>Gas  | UNS<br>Electric |           |           | Other     |
|  |  | -Millions of Dollars- |             |                 |           |           |           |
| <b>Intersegment Revenue</b>                  |  |                       |             |                 |           |           |           |
| <b>Three Months Ended September 30, 2010</b> |  |                       |             |                 |           |           |           |
| Wholesale Sales                              | TEP to UNS Electric  | \$ 2                  | \$          | \$              | \$        | \$        |           |
| Wholesale Sales                              | UNS Electric to TEP  |                       |             |                 | 1         |           |           |
| Wholesale Sales                              | UED to UNS Electric  |                       |             |                 |           |           | 3         |
| Gas Revenue                                  | UNS Gas to UNS Electric                                      |                       | 2           |                 |           |           |           |
| Other Revenue                                | TEP to Affiliat <sup>(4)</sup>                               | 2                     |             |                 |           |           |           |
| Other Revenue                                | Millennium to TEP, UNS Electric,<br>& UNS Gas <sup>(2)</sup> |                       |             |                 |           |           | 5         |
| Other Revenue                                | TEP to UNS Electr <sup>(3)</sup>                             | 1                     |             |                 |           |           |           |
| <b>Total Intersegment Revenue</b>            |  | <b>\$ 5</b>           | <b>\$ 2</b> | <b>\$ 1</b>     | <b>\$</b> | <b>\$</b> | <b>8</b>  |
| <b>Three Months Ended September 30, 2009</b> |  |                       |             |                 |           |           |           |
| Wholesale Sales                              | TEP to UNS Electric  | \$ 9                  | \$          | \$              | \$        | \$        |           |
| Wholesale Sales                              | UNS Electric to TEP  |                       |             |                 | 1         |           |           |
| Wholesale Sales                              | UED to UNS Electric  |                       |             |                 |           |           | 3         |
| Gas Revenue                                  | UNS Gas to UNS Electric                                      |                       | 2           |                 |           |           |           |
| Other Revenue                                | TEP to Affiliat <sup>(4)</sup>                               | 2                     |             |                 |           |           |           |
| Other Revenue                                | Millennium to TEP, UNS Electric,<br>& UNS Gas <sup>(2)</sup> |                       |             |                 |           |           | 4         |
| Other Revenue                                | TEP to UNS Electr <sup>(3)</sup>                             | 1                     |             |                 |           |           |           |
| <b>Total Intersegment Revenue</b>            |  | <b>\$ 12</b>          | <b>\$ 2</b> | <b>\$ 1</b>     | <b>\$</b> | <b>\$</b> | <b>7</b>  |
| <b>Nine Months Ended September 30, 2010</b>  |  |                       |             |                 |           |           |           |
| Wholesale Sales                              | TEP to UNS Electric  | \$ 15                 | \$          | \$              | \$        | \$        |           |
| Wholesale Sales                              | UNS Electric to TEP  |                       |             |                 | 2         |           |           |
| Wholesale Sales                              | UED to UNS Electric  |                       |             |                 |           |           | 8         |
| Gas Revenue                                  | UNS Gas to UNS Electric                                      |                       | 4           |                 |           |           |           |
| Other Revenue                                | TEP to Affiliat <sup>(4)</sup>                               | 6                     |             |                 |           |           |           |
| Other Revenue                                | Millennium to TEP, UNS Electric,<br>& UNS Gas <sup>(2)</sup> |                       |             |                 |           |           | 13        |
| Other Revenue                                | TEP to UNS Electr <sup>(3)</sup>                             | 2                     |             |                 |           |           |           |
| <b>Total Intersegment Revenue</b>            |  | <b>\$ 23</b>          | <b>\$ 4</b> | <b>\$ 2</b>     | <b>\$</b> | <b>\$</b> | <b>21</b> |



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

|  | Reportable Segments |                       |                 |           | Other     |
|--|---------------------|-----------------------|-----------------|-----------|-----------|
|  | TEP                 | UNS<br>Gas            | UNS<br>Electric |           |           |
|  |                     | -Millions of Dollars- |                 |           |           |
| <b>Nine Months Ended September 30, 2009</b>                                |                     |                       |                 |           |           |
| Wholesale Sales TEP to UNS Electric  | \$ 16               | \$                    |                 | \$        |           |
| Wholesale Sales UNS Electric to TEP  |                     |                       |                 | 3         |           |
| Wholesale Sales UED to UNS Electric  |                     |                       |                 |           | 9         |
| Gas Revenue UNS Gas to UNS Electric  |                     | 4                     |                 |           |           |
| Other Revenue TEP to Affiliat <sup>(1)</sup>                               | 6                   |                       |                 |           |           |
| Other Revenue Millennium to TEP, UNS Electric,<br>& UNS Gas <sup>(2)</sup> |                     |                       |                 |           | 12        |
| Other Revenue TEP to UNS Electr <sup>(3)</sup>                             | 2                   |                       |                 |           |           |
| <b>Total Intersegment Revenue</b>  | <b>\$ 24</b>        | <b>\$ 4</b>           | <b>\$ 3</b>     | <b>\$</b> | <b>21</b> |

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

(2) Millennium provides supplemental workforce and meter reading services to TEP, UNS Electric and UNS Gas.

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

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

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

**Reportable Segments****UniSource**

|  | TEP | UNS<br>Gas | UNS<br>Electric | Other | Reconciling<br>Adjustments | Energy<br>Consolidated |
|--|-----|------------|-----------------|-------|----------------------------|------------------------|
|--|-----|------------|-----------------|-------|----------------------------|------------------------|

-Millions of Dollars-

**Income Statement****Three Months Ended September 30,  
2010:**

|                      |              |        |       |       |     |      |     |
|----------------------|--------------|--------|-------|-------|-----|------|-----|
| Operating Revenues   | External     | \$ 350 | \$ 17 | \$ 72 | \$  | \$   | 439 |
| Operating Revenues   | Intersegment | 5      | 2     | 1     | 8   | (16) |     |
| Income (Loss) Before | Income Taxes | 97     | (2)   | 5     | (1) |      | 99  |
| Net Income (Loss)    |              | 59     | (1)   | 3     | (6) |      | 55  |

**Three Months Ended September 30,  
2009:**

|                      |              |        |       |       |     |      |     |
|----------------------|--------------|--------|-------|-------|-----|------|-----|
| Operating Revenues   | External     | \$ 345 | \$ 17 | \$ 52 | \$  | \$   | 414 |
| Operating Revenues   | Intersegment | 12     | 2     | 1     | 7   | (22) |     |
| Income (Loss) Before | Income Taxes | 90     | (2)   | 6     | (1) |      | 93  |
| Net Income (Loss)    |              | 55     | (1)   | 4     |     |      | 58  |

**Nine Months Ended September 30,  
2010:**

|                      |              |        |       |        |      |      |       |
|----------------------|--------------|--------|-------|--------|------|------|-------|
| Operating Revenues   | External     | \$ 835 | \$ 99 | \$ 160 | \$   | \$   | 1,094 |
| Operating Revenues   | Intersegment | 23     | 4     | 2      | 21   | (50) |       |
| Income (Loss) Before | Income Taxes | 156    | 9     | 13     | (4)  |      | 174   |
| Net Income (Loss)    |              | 97     | 5     | 8      | (10) |      | 100   |

**Nine Months Ended September 30,  
2009:**

|                    |              |        |        |        |    |      |       |
|--------------------|--------------|--------|--------|--------|----|------|-------|
| Operating Revenues | External     | \$ 818 | \$ 102 | \$ 144 | \$ | \$   | 1,064 |
| Operating Revenues | Intersegment | 24     | 4      | 3      | 21 | (52) |       |
| Income Before      | Income Taxes | 132    | 6      | 9      | 4  | 1    | 152   |
| Net Income         |              | 81     | 4      | 6      | 3  |      | 94    |

The details of the reconciling adjustments are disclosed in the Intersegment Revenue table above.

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited****NOTE 4. DEBT, CREDIT FACILITIES AND CAPITAL LEASE OBLIGATIONS****UNISOURCE ENERGY CREDIT AGREEMENT**

UniSource Energy had the following balances outstanding under the UniSource Credit Agreement:

|           | <b>Current</b>            | <b>Long-</b> |              | <b>Current</b>           | <b>Long-</b> |              |
|-----------|---------------------------|--------------|--------------|--------------------------|--------------|--------------|
|           | <b>Liabilities</b>        | <b>Term</b>  | <b>Total</b> | <b>Liabilities</b>       | <b>Term</b>  | <b>Total</b> |
|           | <b>September 30, 2010</b> |              |              | <b>December 31, 2009</b> |              |              |
|           | \$                        | \$           | \$           | \$                       | \$           | \$           |
| Revolver  | 29                        |              | 29           | 6                        | 31           | 31           |
| Term Loan | 5                         |              | 5            | 3                        |              | 9            |

On October 15, 2010, UniSource Energy had \$30 million in borrowings outstanding under its revolving credit facility.

**TEP SUNDT UNIT 4 CAPITAL LEASE PURCHASE**

In January 2010, TEP entered into a commitment to purchase 100% of the equity interest in Sundt Unit 4 from the owner participants for \$52 million, resulting in an increase in capital lease assets and the capital lease obligation. In March 2010, TEP paid the owner participants \$52 million reducing the capital lease obligation. In April 2010, TEP paid the final outstanding Sundt Unit 4 lease obligation of \$5 million to terminate the lease and reclassified the capital lease asset and the related leasehold improvements to plant in service. TEP is depreciating the asset over its best estimate of remaining plant life at the time of purchase which is twenty-five years.

**TEP CREDIT AGREEMENT**

At September 30, 2010, TEP had \$55 million in borrowings outstanding and less than \$1 million in letters of credit issued under its revolving credit agreement. The letters of credit were issued to provide credit enhancements for energy purchase contracts and hedging activities. As of December 31, 2009, TEP had \$35 million in borrowings outstanding and \$1 million in letters of credit issued under its revolving credit facility. On October 15, 2010, TEP had less than \$1 million in letters of credit issued under its revolving credit facility, and no outstanding borrowings. The revolving loan balances are included in Current Liabilities in the UniSource Energy and TEP balance sheets.

The TEP Credit Agreement also consists of a \$341 million LOC facility which supports \$329 million of tax-exempt variable rate Industrial Development Revenue Bonds (IDBs) which are included in Current Maturities of Long-Term Debt in the UniSource Energy and TEP balance sheets, as the LOCs supporting the IDBs mature in August 2011. TEP is in the process of refinancing this credit facility and expects the transaction to be completed by the end of 2010.

**TEP DEBT****2010 Pima Series A Bonds Issuance**

In October 2010, the Pima Authority issued \$100 million of its 2010 Series A tax-exempt IDBs for TEP's benefit. The 2010 Pima Series A IDBs are unsecured, bear interest at a rate of 5.25%, mature in October 2040, and are callable at par on or after October 1, 2020. Net of an underwriting discount, \$99 million of proceeds were deposited in a construction fund with the bond trustee. The proceeds were applied to the construction of certain of TEP's transmission and distribution facilities used to provide electric service in Pima County. TEP drew down \$74 million of the proceeds from the construction fund at closing, with the remaining \$25 million expected to be drawn down by the end of the first quarter of 2011.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**  
**TEP Term Loan Borrowing**

In March 2010, TEP entered into an 18-month, \$30 million term loan facility secured by \$30 million of TEP mortgage bonds which is included in Current Maturities of Long-Term Debt in the UniSource Energy and TEP balance sheets. In October 2010, TEP repaid the term loan.

**2008 Pima B Bonds Interest Conversion**

In January 2010, TEP converted the interest on the \$130 million of 2008 Pima B Bonds from a variable rate to a fixed rate. The Pima B Bonds were reoffered in January 2010, with a term rate of 5.75% through maturity on September 2029. Interest is payable semi-annually beginning June 1, 2010. The bonds are callable at par beginning January 2015. Accordingly, the associated letter of credit which supported the 2008 variable rate Pima B Bonds was terminated on January 12, 2010, and the TEP mortgage bonds which collateralized the letter of credit were canceled. TEP capitalized \$1 million of costs related to the transaction that will amortize as interest expense through September 2029.

**UNS GAS/UNS ELECTRIC REVOLVING CREDIT AGREEMENT**

UNS Electric had \$18 million and \$11 million in outstanding letters of credit under the UNS Gas/UNS Electric Revolver as of September 30, 2010 and December 31, 2009, respectively, which are not shown on the balance sheet. As of October 15, 2010, UNS Electric had \$18 million of outstanding letters of credit under the UNS Gas/UNS Electric Revolver.

**UED BORROWINGS**

In February 2010, UED amended its senior secured term loan facility to extend the termination date by two years to March 2012, and to increase borrowings by \$9 million bringing the outstanding balance to \$35 million. UED capitalized less than \$1 million in costs related to the transaction. As of September 30, 2010, UED owed \$32 million under the UED Credit Agreement.

**OTHER**

As of September 30, 2010, UniSource Energy and its subsidiaries were in compliance with the terms of their respective loan and credit agreements.

**NOTE 5. INCOME TAXES**

**EFFECTIVE TAX RATE**

For the quarter ended September 30, 2010, UniSource Energy's effective tax rate of 45% differed from the federal rate of 35% primarily due to state income taxes, the impact of the domestic production activities deduction, and deferred tax asset write-offs and valuation allowance adjustments. For the quarter ended September 30, 2009 UniSource Energy's effective tax rate of 38% differed from the federal rate of 35% primarily due to state income taxes and the impact of the domestic production activities deduction.

For the quarters ended September 30, 2010, and September 30, 2009, TEP's effective tax rate of 39% differed from the federal rate of 35%, primarily due to state income taxes and the impact of the domestic production activities deduction.

In estimating the annual effective tax rate for 2010, UniSource Energy and TEP included a \$3 million tax benefit for the domestic production activities deduction as of June 30, 2010. On September 27, 2010, the President signed the Small Business Jobs Act which extended bonus depreciation on capital investments. As a result of the reduction in taxable income from the increase in depreciation, UniSource Energy and TEP have reduced the estimated tax benefit of the domestic production activities deduction to \$1 million as of September 30, 2010.

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

The 2010 annual effective tax rate for UniSource Energy and TEP includes a \$1 million tax benefit for a Federal Energy Credit. The credit is contingent on the construction of solar facilities being completed by December 31, 2010. The construction of the facilities is expected to be complete by year end.

**DEFERRED TAX ASSETS**

The following table summarizes UniSource Energy's deferred tax assets relating to Millennium.

|                            | <b>Deferred<br/>Tax Asset</b> | <b>Valuation<br/>Allowance</b> | <b>Deferred<br/>Tax Asset</b>     | <b>Valuation<br/>Allowance</b>    | <b>Income Tax<br/>Expense for<br/>the Quarter<br/>Ended</b> |
|----------------------------|-------------------------------|--------------------------------|-----------------------------------|-----------------------------------|---|
|                            | <b>June 30,<br/>2010</b>      | <b>June 30,<br/>2010</b>       | <b>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2010</b> | <b>September 30,<br/>2010</b>                               |
| -Millions of Dollars-      |                               |                                |                                   |                                   |   |
| Realized Capital Losses    | \$ 5                          | \$ (3)                         | \$ 5                              | \$ (3)                            | \$  |
| Unrealized Capital Losses  | 2                             |                                | 3                                 | (3)                               | 3   |
| Unrealized Ordinary Losses | 1                             |                                | 1                                 |                                   |   |
| Investment in Subsidiary   | 3                             |                                |                                   |                                   | 3   |
| <b>Total</b>               | <b>\$ 11</b>                  | <b>\$ (3)</b>                  | <b>\$ 9</b>                       | <b>\$ (6)</b>                     | <b>\$ 6</b>   |

|                            | <b>Deferred<br/>Tax Asset</b>    | <b>Valuation<br/>Allowance</b>   | <b>Deferred<br/>Tax Asset</b>     | <b>Valuation<br/>Allowance</b>    | <b>Income Tax<br/>Expense for<br/>the Nine<br/>Months<br/>Ended</b> |
|----------------------------|----------------------------------|----------------------------------|-----------------------------------|-----------------------------------|---|
|                            | <b>December<br/>31,<br/>2009</b> | <b>December<br/>31,<br/>2009</b> | <b>September<br/>30,<br/>2010</b> | <b>September<br/>30,<br/>2010</b> | <b>September 30,<br/>2010</b>                                       |
| -Millions of Dollars-      |                                  |                                  |                                   |                                   |   |
| Realized Capital Losses    | \$                               | \$                               | \$ 5                              | \$ (3)                            | \$ 1  |
| Unrealized Capital Losses  | 5                                |                                  | 3                                 | (3)                               | 3   |
| Unrealized Ordinary Losses |                                  |                                  | 1                                 |                                   |   |
| Investment in Subsidiary   | 3                                |                                  |                                   |                                   | 3   |
| <b>Total</b>               | <b>\$ 8</b>                      | <b>\$</b>                        | <b>\$ 9</b>                       | <b>\$ (6)</b>                     | <b>\$ 7</b>   |

UniSource Energy and TEP had no valuation allowances in 2009.

**Capital Losses**

Corporate capital losses can reduce taxable income if there are offsetting capital gains during the current year, the 3-year carryback period, or the 5-year carryforward period. If the capital losses remain unused after the 5-year carryforward period, they expire. Management expects to use \$2 million of the capital loss deferred tax asset during the 3-year carryback period. The remaining capital loss deferred tax asset of \$6 million will be carried forward to future years to offset any future capital gains. This amount has been fully offset by a valuation allowance at September 30, 2010 because management does not believe it is more likely than not the Company will generate future capital gains prior to the expiration date of the loss carryforward.

**Unrealized Ordinary Losses**



Based upon the Company's current and historical pre-tax earnings, management believes it is more likely than not that the Company will realize the benefit of its ordinary loss deferred tax asset.

**Investment in Subsidiary**

For the quarter ended September 30, 2010, UniSource Energy recorded a \$3 million out-of-period income tax expense. The out-of-period expense related to the write-off of a previously recorded deferred tax asset associated with the excess of tax over book basis difference in a consolidated Millennium investment. Management concluded that this out-of-period adjustment was not material to the current and prior period financial statements.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited  
UNCERTAIN TAX POSITIONS**

As a result of the expiration of the statute of limitations for the 2005 and 2006 tax years, UniSource Energy and TEP recorded a \$2 million reduction to interest expense relating to uncertain tax positions during the quarter ended September 30, 2010.

**NOTE 6. COMMITMENTS AND CONTINGENCIES**

**TEP COMMITMENTS**

**Firm Purchase Commitments**

In 2010, TEP entered into new long-term, forward purchase power commitments in addition to those reported in our 2009 Annual Report on Form 10-K. These contracts will settle in June 2011 through September 2011 with prices that are indexed to natural gas prices. TEP's estimated minimum payment obligation for these purchases is \$15 million based on projected market prices as of September 30, 2010.

**UNS ELECTRIC COMMITMENTS**

In 2010, UNS Electric entered into forward power purchase agreements through December 2012. UNS Electric estimates its minimum payments for these forward purchases to be \$25 million in 2011 and \$7 million in 2012. Certain of these purchased power contracts are at a fixed price per MWh and others are indexed to natural gas prices. For indexed contracts, commitments are based on projected market prices as of September 30, 2010.

**UNS GAS COMMITMENTS**

In 2010, UNS Gas entered into forward gas purchase agreements through May 2015. UNS Gas estimates its minimum payments for these forward purchases to be \$4 million in 2011 and 2012, \$2 million in 2013 and less than \$1 million in each of 2014 and 2015.

**UNISOURCE ENERGY COMMITMENTS**

In 2009, UniSource Energy purchased land to construct a new headquarters building in downtown Tucson. In April 2010, UniSource Energy signed a design-build contract committing to a payment of \$26 million for the first and second phases of the construction project of which \$18 million remained an outstanding commitment at September 30, 2010. We expect to spend a total of \$75 million on the building including furniture, fixtures and equipment. UniSource Energy expects the building to be completed and in service by November 2011.

**RENEWABLE ENERGY PURCHASE POWER AGREEMENTS AND PROJECTS**

TEP and UNS Electric entered into various forward power purchase agreements with developing renewable energy generation facilities to meet compliance requirements under the RES tariff. The facilities are expected to begin commercial operation in 2011. Additionally, TEP entered into contracts to develop TEP owned renewable energy projects for \$14 million of which \$6 million remained an outstanding commitment at September 30, 2010. See Note 2 for additional information on RES related contracts.

**TEP CONTINGENCIES**

**El Paso Electric Transmission**

In 2006, El Paso filed a complaint with the FERC claiming that TEP must request service under El Paso's Open Access Transmission Tariff (OATT) in order to transmit power from Luna to TEP's system. TEP filed a counter complaint stating that TEP has existing rights under a 1982 Tucson-El Paso Transmission Agreement and, therefore, is not required to pay for transmission service under El Paso's OATT. In November 2008, the FERC issued an order supporting TEP's position.

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

In December 2008, pending resolution, El Paso refunded to TEP \$10 million paid for transmission service from Luna to TEP's system during the period 2006 to 2008 and interest of \$1 million. TEP is not currently paying or accruing for transmission service under El Paso's OATT.

In July 2010, the FERC issued an order denying El Paso's request for rehearing of FERC's November 2008 order. In July, El Paso filed an appeal in the United States Court of Appeals for the District of Columbia Circuit. TEP intervened in the appeal proceeding. TEP has not recognized income as a result of the July 2010 FERC decision.

If El Paso were to prevail in its appeal, TEP would be required to pay for transmission service under El Paso's OATT from October 2008 through the date of the decision. For the period October 2008 to September 30, 2010, this additional transmission expense would approximate \$8 million. However, under the PPFA mechanism, TEP would be allowed to recover \$7 million of this additional transmission expense from its retail customers.

In December 2008, TEP filed a complaint in the United States Federal District Court against El Paso seeking a \$2 million reimbursement from El Paso for transmission charges paid by TEP to Public Service Company of New Mexico (PNM) for transmission service in an attempt to mitigate TEP's damages before FERC issued its decision in November 2008. In September 2009, the District Court denied El Paso's motion to dismiss TEP's complaint and stayed the proceeding pending a final resolution of the FERC proceedings and any appeal.

TEP cannot predict the timing or outcome of these lawsuits.

**Claims Related to Navajo Generating Station**

In June 1999, the Navajo Nation filed suit against Salt River Project (SRP), several Peabody Coal Company entities including Peabody Western Coal Company (Peabody), the coal supplier to Navajo Generating Station (Navajo), Southern California Edison Company, and other defendants in the U.S. District Court for the District of Columbia (D.C. Lawsuit). Although TEP is not a named defendant in the D.C. Lawsuit, TEP owns 7.5% of Navajo Units 1, 2 and 3. The D.C. Lawsuit alleges, among other things, that the defendants obtained a favorable coal royalty rate on the lease agreements under which Peabody mines coal by improperly influencing the outcome of a federal administrative process pursuant to which the royalty rate was to be adjusted. The suit seeks \$600 million in damages, treble damages, punitive damages of not less than \$1 billion, and the ejection of defendants from all possessory interests and Navajo Tribal lands arising out of the primary coal lease.

In July 2001, the District Court dismissed all claims against SRP. In March 2008, the District Court lifted a stay that had been in place since October 2004 and referred pending discovery related motions to a magistrate judge. In January 2010, the District Court extended the discovery deadline and set other procedural deadlines at various dates between March 2010 and February 2011. In April 2010, the Navajo Nation filed a Second Amended Complaint. In September 2010, the case was referred to the District Court's mediation program to assist with settlement negotiations. In 2004, Peabody filed a complaint in the Circuit Court for the City of St. Louis, Missouri against the participants at Navajo, including TEP, for reimbursement of royalties and other costs arising out of the D.C. Lawsuit. In July 2008, the parties entered into a joint stipulation of dismissal of these claims which was approved by the Circuit Court. TEP cannot predict whether the lawsuit will be refiled based upon the final outcome of the D.C. Lawsuit.

**Claims Related to San Juan Generating Station**

In April 2010, the Sierra Club filed a citizens suit under the Resource Conservation and Recovery Act (RCRA) and the Surface Mine Control and Reclamation Act (SMCRA) in the U.S. District Court for the District of New Mexico against PNM, as operator of San Juan, PNM parent PNM Resources, Inc. (PNMR), San Juan Coal Company (SJCC), which operates the San Juan mine that supplies coal to San Juan, and SJCC's parent BHP Minerals International Inc. (BHP). The Sierra Club alleges in the suit that certain activities at San Juan and the San Juan mine associated with the treatment, storage and disposal of coal and coal combustion residuals (CCRs), primarily coal ash, are causing imminent and substantial harm to the environment, including ground and surface water in the region, and that placement of CCRs at the mine constitute open dumping in violation of RCRA. The RCRA claims are asserted against PNM, PNMR, SJCC and BHP. The suit also includes claims under SMCRA which are directed only against SJCC and BHP. The suit seeks the following relief: an injunction requiring the parties to undertake certain mitigation measures with respect to the placement of CCRs at the mine or to cease placement of CCRs at the mine; the imposition of civil penalties; and, attorney's fees and costs. On July 10, 2010, the Sierra Club filed an amended complaint that corrected

some technical deficiencies in its original complaint. The factual allegations remained the same. The parties have agreed to and the court has entered a stay of the action on August 27, 2010 to allow the parties to try to address Sierra Club's concerns. If the parties are unable to settle the matter, PNM plans an aggressive defense of the RCRA claims in the suit. TEP owns 50% of San Juan Units 1 and 2, which represents approximately 20% of the total generation capacity of the entire San Juan Generation Station, and is liable for its share of any resulting liabilities. TEP cannot predict the outcome of this matter at this time.

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SJCC, the coal supplier to San Juan, through leases with the federal government and the State of New Mexico, owns coal interests with respect to an underground mine that supplies coal to San Juan. Certain gas producers have oil and gas leases with the federal government, the State of New Mexico and private parties in the area of the underground mine. These gas producers allege that SJCC's underground coal mining operations have or will interfere with their gas production and will reduce the amount of natural gas that they would otherwise be entitled to recover. SJCC has compensated certain gas producers for any remaining gas production from a well when it was determined that mining activity was close enough to warrant shutting down the well. These settlements, however, do not resolve all potential claims by gas producers in the underground mine area. TEP owns 50% of San Juan Units 1 and 2, which represents approximately 20% of the total generation capacity of the entire San Juan Generation Station, and is liable for its share of any resulting liabilities. TEP cannot estimate the impact of any future claims by these gas producers on the cost of coal at San Juan.

**Regional Haze Rules**

The EPA's regional haze rules require emission controls known as Best Available Retrofit Technology (BART) for certain industrial facilities emitting air pollutants that reduce visibility. The rules call for all states to establish goals and emission reduction strategies for improving visibility in national parks and wilderness areas and to submit a state implementation plan to the EPA.

**San Juan**

In June 2010, the New Mexico Environment Department (NMED) filed its proposed regional haze state implementation plan with the New Mexico Environmental Improvement Board. The plan proposes that the BART for nitrogen oxides at San Juan is a technology known as selective catalytic reduction (SCR) plus sorbent injection. PNM, the operator at San Juan, previously analyzed SCR and concluded it was not the BART and intends to vigorously challenge the NMED's proposal.

TEP's share of installing SCRs with sorbent injection is estimated to be \$171 million. This estimate is based on PNM's 2007 analysis of the cost of installation of SCR technology and more recent estimates of the cost of installing sorbent injection. Adding these technologies to San Juan would also increase operating costs at the generating station. Once the EPA approves an implementation plan for New Mexico, the San Juan participants would have five years to achieve compliance.

**Four Corners Generating Station (Four Corners)**

In October 2010, EPA issued a proposed federal implementation plan (FIP) for BART at the Four Corners. The proposed FIP, if approved, would require the installation of SCRs on units 1 through 5 and baghouses on units 1 through 3. TEP has a 7% interest in units 4 and 5. TEP's estimated share of the installation cost for SCRs for units 4 and 5 is approximately \$38 million. Once the EPA finalizes the BART rule for Four Corners, the Four Corners participants would have five years to achieve compliance.

TEP cannot predict the ultimate outcome of these matters.

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

TEP currently pays on-going reclamation costs related to the coal mines which supply the generating stations in which TEP has an ownership interest but does not operate. It is probable that TEP will have to pay a portion of final reclamation costs upon closure of these mines. TEP's share of the reclamation costs at the expiration dates of the coal supply agreements in 2016 through 2019 approximates \$26 million. TEP recognizes this liability over the remaining terms of the coal supply agreements and had recorded liabilities of \$10 million at September 30, 2010 and December 31, 2009.

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

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

**California Energy Market Issues**

In March 2010, TEP and the California Attorney General, California Public Utilities Commission and various private entities (collectively California Parties) reached a settlement in principal of all remaining claims against TEP related to TEP's transactions in the Western energy markets including the California Power Exchange and the California Independent System Operator during the California energy crisis of 2000 and 2001. As a result of the settlement with the California Parties, TEP recognized an additional liability of \$4 million in March 2010, bringing TEP's gross liability related to these claims to \$6 million.

In April 2010, TEP and the California Parties entered into a written settlement agreement that FERC approved in June 2010, and TEP paid the liability in July 2010. Also, in association with the California Parties settlement, in March 2010, TEP recorded a receivable from SRP for approximately \$1 million, that has since been settled, related to a long-term power sale agreement between TEP and SRP. The net \$3 million is shown as California Power Exchange (CPX) Provision for Wholesale Refunds on TEP's income statement. In addition, in March 2010, UNS Electric reached a related settlement with Arizona Public Service Company (APS) and recorded Other Income of \$3 million that has since been received in cash. The settlements described above offset and had no impact on UniSource Energy's consolidated results in the first three quarters of 2010.

**Tucson to Nogales Transmission Line**

TEP and UNS Electric are parties to a project development agreement for the joint construction of an approximately 60-mile transmission line from Tucson to Nogales, Arizona. UNS Electric's participation in this project was initiated in response to an order by the ACC to improve reliability to UNS Electric's retail customers in Nogales, Arizona. In 2002, the ACC approved the location and construction of the proposed 345-kV line along a route identified as the Western Corridor route subject to a number of conditions, including obtaining all required permits from state and federal agencies. The U.S. Forest Service subsequently identified a preference for a route identified as the Central Corridor route in the final Environmental Impact Statement for the project. TEP is considering options for the project including potential new routes. If a decision is made to pursue an alternative route, approvals will be needed from the ACC, the Department of Energy, U.S. Forest Service, Bureau of Land Management, and the International Boundary and Water Commission. As of September 30, 2010, TEP had capitalized \$11 million related to the project, including \$2 million of land and land rights. If TEP does not receive the required approvals or abandons the project, TEP believes cost recovery is probable for prudent and reasonably incurred costs related to the project as a consequence of the ACC's requirement for a second transmission line serving the Nogales, Arizona area.

**GUARANTEES**

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

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



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

UniSource Energy's guarantee of approximately \$2 million in building lease payments for UNS Gas; and  
 UniSource Energy's guarantee of the \$32 million of outstanding loans under the UED Credit Agreement.

To the extent liabilities exist under these contracts, the liabilities are included in our consolidated balance sheets. We believe that the likelihood UniSource Energy or UES would be required to perform or otherwise incur any significant losses associated with any of these guarantees is remote.

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

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

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

The carrying amounts of our current assets and liabilities, including Current Maturities of Long-Term Debt, term loans, and amounts outstanding under our credit agreements, approximate their fair value due to the short-term nature of these instruments; with the exception of \$50 million of UNS Gas Senior Unsecured Notes with a make-whole provision on a call premium that have a fair value of \$52 million. These items have been excluded from the table below.

Investments in Lease Debt and Equity: TEP calculated the present value of remaining cash flows at the balance sheet date using current market rates for instruments with similar characteristics with respect to credit rating and time-to-maturity. We also incorporated the impact of counterparty credit risk using market credit default swap data.

Fixed Rate Long-Term Debt: UniSource Energy and TEP used quoted market prices, where available, or calculated the present value of remaining cash flows at the balance sheet date using current market rates for bonds with similar characteristics with respect to credit rating and time-to-maturity. We also incorporate the impact of our own credit risk using a credit default swap rate when determining the fair value of fixed rate long-term debt.

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

|   | September 30,<br>2010 |               | December 31,<br>2009 |               |
|---|-----------------------|---------------|----------------------|---------------|
|   | Carrying<br>Value     | Fair<br>Value | Carrying<br>Value    | Fair<br>Value |
|   | -Millions of Dollars- |               |                      |               |
| <b>Assets:</b>                          |                       |               |                      |               |
| TEP Investment in Lease Debt and Equity | \$ 106                | \$ 113        | \$ 132               | \$ 140        |
| Millennium Note Receivable              | 15                    | 15            | 15                   | 15            |
| <b>Liabilities:</b>                     |                       |               |                      |               |
| Fixed Rate Long-Term Debt               |                       |               |                      |               |
| TEP                                     | 575                   | 477           | 445                  | 336           |
| UniSource Energy                        | 875                   | 809           | 795                  | 693           |
| Variable Rate Long-Term Debt            |                       |               |                      |               |
| UniSource Energy and TEP                |                       |               | 459                  | 452           |





**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited****NOTE 8. EMPLOYEE BENEFIT PLANS****PENSION BENEFIT PLANS**

The three utilities maintain noncontributory, defined benefit pension plans for substantially all regular employees and certain affiliate employees. Benefits are based on years of service and the employee's average compensation. The three utilities fund the plans by contributing at least the minimum amount required under Internal Revenue Service regulations.

We recognize the underfunded status of our defined benefit pension plans as a liability on our consolidated balance sheets. The underfunded status is measured as the difference between the fair value of the plan's assets and the projected benefit obligation for pension plans. We recognize a regulatory asset to the extent these future costs are probable of recovery in rates.

Additionally, we provide supplemental retirement benefits to certain employees whose benefits are limited by Internal Revenue Service benefit or compensation limitations. Changes in Supplemental Executive Retirement Plan (SERP) benefit obligations are recognized as a component of accumulated other comprehensive income (AOCI).

**OTHER POSTRETIREMENT BENEFIT PLANS**

TEP provides limited health care and life insurance benefits for retirees. All regular employees may become eligible for these benefits if they reach retirement age while working for TEP or an affiliate. UNS Gas and UNS Electric provide postretirement medical benefits for current retirees. UNS Gas and UNS Electric active employees do not participate in the postretirement medical plan.

**COMPONENTS OF NET PERIODIC BENEFIT COST**

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

|  | <b>Pension Benefits</b>             |             | <b>Other Postretirement Benefits</b> |             |
|--|-------------------------------------|-------------|--------------------------------------|-------------|
|  | Three Months Ended<br>September 30, |             | Three Months Ended<br>September 30,  |             |
|  | <b>2010</b>                         | <b>2009</b> | <b>2010</b>                          | <b>2009</b> |
|  | -Millions of Dollars-               |             |                                      |             |
| <b>Components of Net Periodic Benefit Cost</b> |                                     |             |                                      |             |
| Service Cost                                   | \$ 2                                | \$ 2        | \$                                   | \$          |
| Interest Cost                                  | 4                                   | 4           | 1                                    | 1           |
| Expected Return on Plan Assets                 | (3)                                 | (3)         |                                      |             |
| Amortization of Net Loss                       | 1                                   | 2           |                                      |             |
| <b>Net Periodic Benefit Cost</b>               | <b>\$ 4</b>                         | <b>\$ 5</b> | <b>\$ 1</b>                          | <b>\$ 1</b> |

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

The table above includes pension benefit costs of less than \$0.5 million and other postretirement benefit costs of less than \$0.1 million for UNS Gas and UNS Electric.

|  | <b>Pension Benefits</b>            |              | <b>Other Postretirement Benefits</b> |             |
|--|------------------------------------|--------------|--------------------------------------|-------------|
|  | Nine Months Ended<br>September 30, |              | Nine Months Ended<br>September 30,   |             |
|  | <b>2010</b>                        | <b>2009</b>  | <b>2010</b>                          | <b>2009</b> |
|  | -Millions of Dollars-              |              |                                      |             |
| <b>Components of Net Periodic Benefit Cost</b> |                                    |              |                                      |             |
| Service Cost                                   | \$ 6                               | \$ 6         | \$ 2                                 | \$ 2        |
| Interest Cost                                  | 11                                 | 11           | 3                                    | 3           |
| Expected Return on Plan Assets                 | (10)                               | (8)          |                                      |             |
| Amortization of Prior Service Cost             |                                    |              | (1)                                  | (1)         |
| Amortization of Net Loss                       | 4                                  | 5            |                                      |             |
| <b>Net Periodic Benefit Cost</b>               | <b>\$ 11</b>                       | <b>\$ 14</b> | <b>\$ 4</b>                          | <b>\$ 4</b> |

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

**NOTE 9. SHARE-BASED COMPENSATION PLANS****RESTRICTED STOCK UNITS AND PERFORMANCE SHARES****Restricted Stock Units**

In May 2010, the Compensation Committee of the UniSource Energy Board of Directors granted 15,620 restricted stock units to non-employee directors at a grant date fair value of \$31.69 per share. The restricted stock units vest in one year or immediately upon death, disability, or retirement. Compensation expense equal to the fair value on the grant date is recognized over the vesting period. Fully vested but undistributed stock unit awards accrue dividend equivalent stock units based on the fair value of common shares on the date the dividend is paid. In the January following the year the person is no longer a Director, Common Stock shares will be issued for the vested stock units.

**Performance Shares**

In February 2010, the Compensation Committee of the UniSource Energy Board of Directors granted 93,720 performance share awards (targeted shares) to Officers. 50% of the performance share awards had a grant date fair value, based on a Monte Carlo simulation, of \$31.26 per share and will be paid out in shares of UniSource Energy Common Stock based on targeted, cumulative UniSource Energy Total Shareholder Return during the performance period of January 1, 2010 through December 31, 2012, compared to the Total Shareholder Return over the same period of an industry or peer group. The remaining 50% had a grant date fair value of \$30.52 per share and will be paid out in shares of UniSource Energy Common Stock based on cumulative net income for the 3-year period ended December 31, 2012. The performance shares vest based on goal attainment upon completion of the performance period; any unearned awards are forfeited. Performance shares are eligible for dividend equivalents during the performance period.

**SHARE-BASED COMPENSATION EXPENSE**

UniSource Energy and TEP recorded share-based compensation expense, net of amounts capitalized of \$1 million, for each of the three months ended September 30, 2010 and 2009 and \$2 million for each of the nine months ended September 30, 2010 and 2009.

At September 30, 2010, the total unrecognized compensation cost related to non-vested share-based compensation was \$4 million, which will be recorded as compensation expense over the remaining vesting periods through December 2012. The total number of shares awarded but not yet issued, including target performance based shares, under the share-based compensation plans at September 30, 2010, was 1 million.



**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited****NOTE 10. FAIR VALUE MEASUREMENTS**

The following tables set forth, by level within the fair value hierarchy, UniSource Energy and TEP's financial assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2010, and December 31, 2009. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. There were no transfers between Levels 1, 2 or 3 for either reporting period.

|  | Quoted Prices<br>in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | UniSource Energy  |  | Total       |
|--|--|---|--|-------------|
|  |  | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |             |
| <b>September 30, 2010</b><br>- Millions of Dollars -   |  |   |  |             |
| <b>Assets</b>  |  |   |  |             |
| Cash Equivalents <sup>(1)</sup>  | \$ 34  | \$  | \$   | \$ 34       |
| Rabbi Trust Investments to support the<br>Deferred Compensation and SERP Plans<br><sup>(2)</sup> |  | 15  |  | 15          |
| Equity Investments <sup>(3)</sup>  |  |   | 1  | 1           |
| Collateral Posted <sup>(4)</sup>   |  | 3   |  | 3           |
| Energy Contracts <sup>(5)</sup>  |  |   | 16   | 16          |
| <b>Total Assets</b>  | <b>34</b>  | <b>18</b>   | <b>17</b>  | <b>69</b>   |
| <b>Liabilities</b>   |  |   |  |             |
| Energy Contracts <sup>(5)</sup>  |  | (25)  | (30)   | (55)        |
| Interest Rate Swaps <sup>(6)</sup>   |  | (13)  |  | (13)        |
| <b>Total Liabilities</b>   |  | <b>(38)</b>   | <b>(30)</b>  | <b>(68)</b> |
| <b>Net Total Assets and (Liabilities)</b>  | <b>\$ 34</b>   | <b>\$ (20)</b>  | <b>\$ (13)</b>                                     | <b>\$ 1</b> |

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

|  | <b>TEP</b>  |                              |    |                             |              |
|--|---|------------------------------|----|-----------------------------|--------------|
|  | <b>Quoted Prices<br/>in<br/>Active<br/>Markets for<br/>Identical<br/>Assets<br/>(Level 1)</b> | <b>Significant<br/>Other</b> |    | <b>Significant</b>          |              |
|  |   | <b>Observable</b>            |    | <b>Unobservable</b>         |              |
|  |   | <b>Inputs<br/>(Level 2)</b>  |    | <b>Inputs<br/>(Level 3)</b> |              |
|  |   | <b>September 30, 2010</b>    |    |                             | <b>Total</b> |
|  |   | - Millions of Dollars -      |    |                             |              |
| <b>Assets</b>  |   |                              |    |                             |              |
| Cash Equivalents <sup>(1)</sup>  | \$ 10   | \$                           |    | \$                          | \$ 10        |
| Rabbi Trust Investments to support the<br>Deferred Compensation and SERP Plans<br><sup>(2)</sup> |   |                              | 15 |                             | 15           |
| Energy Contracts <sup>(5)</sup>  |   |                              |    | 5                           | 5            |
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|   |           |           |           |             |           |            |           |             |
|---|-----------|-----------|-----------|-------------|-----------|------------|-----------|-------------|
| <b>Total Assets</b>                       |           | <b>10</b> |           | <b>15</b>   |           | <b>5</b>   |           | <b>30</b>   |
| <b>Liabilities</b>                        |           |           |           |             |           |            |           |             |
| Energy Contracts <sup>(5)</sup>           |           |           |           | <b>(8)</b>  |           | <b>(3)</b> |           | <b>(11)</b> |
| Interest Rate Swaps <sup>(6)</sup>        |           |           |           | <b>(13)</b> |           |            |           | <b>(13)</b> |
| <b>Total Liabilities</b>                  |           |           |           | <b>(21)</b> |           | <b>(3)</b> |           | <b>(24)</b> |
| <b>Net Total Assets and (Liabilities)</b> | <b>\$</b> | <b>10</b> | <b>\$</b> | <b>(6)</b>  | <b>\$</b> | <b>2</b>   | <b>\$</b> | <b>6</b>    |

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

(1) Cash Equivalents are based on observable market prices and are comprised of the fair value of commercial paper, money market funds and certificates of deposit.

(2) Rabbi Trust Investments consist of amounts held in mutual and money market funds related to deferred compensation and



SERP benefits. The valuation is based on quoted prices, traded in active markets. These investments are included in Investments and Other Property Other in the UniSource Energy and TEP balance sheets.

- (3) Equity Investments are, in the absence of readily ascertainable market values, based on the investment partner's valuations and comprise Millennium's equity investments in unregulated businesses. These investments are included in Investments and Other Property Other in the UniSource Energy balance sheet.
- (4) Collateral provided for energy contracts with counterparties to reduce credit risk exposure. Collateral posted is included in Current Assets Other in the UniSource Energy balance sheet.
- (5) Energy Contracts include gas swap agreements (Level 2), forward power purchase and sales contracts (Level 3), and forward power

purchase contracts indexed to gas (Level 3), entered into to reduce exposure to energy price risk. These contracts are included in Derivative Instruments in the UniSource Energy and TEP balance sheets. The valuation techniques are described below. See Note 17 for additional information.

- (6) Interest Rate Swaps are valued based on the 6-month LIBOR index or the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap index. These interest rate swaps are included in Derivative Instruments in the UniSource Energy and TEP balance sheets.

### **Energy Contracts**

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

Derivatives valued using an aggregate pricing service or published prices that represent a consensus reporting of multiple brokers are categorized in Level 3. For both power and gas prices, TEP and UNS Electric obtain quotes from brokers, major market participants, exchanges or industry publications as well as its own price experience from active transactions in the market. TEP and UNS Electric primarily use one set of quotations each for power and for gas, and then use the other sources as validation of those prices. The broker providing quotes for power prices states that the market information provided is indicative only, but believes it to be reflective of market conditions as of the time and date indicated. In addition, energy derivatives include contracts where published prices are not readily available. These include contracts for delivery periods during non-standard time blocks, contracts for delivery during only a few months of a given year when prices are quoted only for the annual average, or contracts for delivery at illiquid delivery points. In these cases, TEP and UNS Electric apply certain management assumptions to value such contracts. These assumptions include applying percentage multipliers to value non-standard time blocks, applying historical

price curve relationships to calendar year quotes, and including adjustments for transmission and line losses to value contracts at illiquid delivery points. We also consider the impact of counterparty credit risk using current and historical default and recovery rates as well as our own credit risk using market credit default swap data. TEP and UNS Electric review these assumptions on a quarterly basis.

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

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

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

|  | <b>Three Months Ended<br/>September 30, 2010</b> |                               |                |                             |
|--|--|-------------------------------|----------------|-----------------------------|
|  | - Millions of Dollars -                          |                               |                |                             |
|  | <b>UniSource Energy</b>                          |                               |                | <b>TEP</b>                  |
|  | <b>Energy<br/>Contracts</b>                      | <b>Equity<br/>Investments</b> | <b>Total</b>   | <b>Energy<br/>Contracts</b> |
| <b>Balance, as of July 1, 2010</b>   | \$ (11)  | \$ 1                          | \$ (10)        | \$ 2                        |
| Gains and (Losses) (Realized/Unrealized) Recorded to:  |  |                               |                |                             |
| Net Regulatory Assets-Derivative Instruments   | (3)  |                               | (3)            |                             |
| Other Comprehensive Income   |  |                               |                |                             |
| Other Expense  |  |                               |                |                             |
| <b>Balance, as of September 30, 2010</b>   | <b>\$ (14)</b>                                   | <b>\$ 1</b>                   | <b>\$ (13)</b> | <b>\$ 2</b>                 |
| Total gains (losses) attributable to the change in unrealized gains or losses relating to assets/liabilities still held at the end of the period | \$ (6)   | \$                            | \$ (6)         | \$ 1                        |

|  | <b>Nine Months Ended<br/>September 30, 2010</b> |                               |                |                             |
|--|---|-------------------------------|----------------|-----------------------------|
|  | - Millions of Dollars -                         |                               |                |                             |
|  | <b>UniSource Energy</b>                         |                               |                | <b>TEP</b>                  |
|  | <b>Energy<br/>Contracts</b>                     | <b>Equity<br/>Investments</b> | <b>Total</b>   | <b>Energy<br/>Contracts</b> |
| <b>Balance, as of January 1, 2010</b>  | \$ (13)   | \$ 6                          | \$ (7)         | \$ (4)                      |
| Gains and (Losses) (Realized/Unrealized) Recorded to:  |   |                               |                |                             |
| Net Regulatory Assets-Derivative Instruments   | 1   |                               | 1              | 8                           |
| Other Comprehensive Income   | (2)   |                               | (2)            | (2)                         |
| Other Expense  |   | (5)                           | (5)            |                             |
| <b>Balance, as of September 30, 2010</b>   | <b>\$ (14)</b>                                  | <b>\$ 1</b>                   | <b>\$ (13)</b> | <b>\$ 2</b>                 |
| Total gains (losses) attributable to the change in unrealized gains or losses relating to assets/liabilities still held at the end of the period | \$ (7)  | \$                            | \$ (7)         | \$ 6                        |

Gains and losses on energy contracts include the reclassification of realized gains and losses on the settlement of derivative contracts.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited****NOTE 11. UNISOURCE ENERGY EARNINGS PER SHARE (EPS)**

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

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

|   | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|---|-------------------------------------|-----------|------------------------------------|-----------|
|   | 2010                                | 2009      | 2010                               | 2009      |
|   | -Thousands of Dollars-              |           |                                    |           |
| Numerator:  |                                     |           |                                    |           |
| Net Income  | \$ 54,883                           | \$ 57,646 | \$ 100,395                         | \$ 93,839 |
| Income from Assumed Conversion of Convertible Senior Notes                        | 1,097                               | 1,097     | 3,292                              | 3,292     |
| Adjusted Numerator  | \$ 55,980                           | \$ 58,743 | \$ 103,687                         | \$ 97,131 |
|   | - Thousands of Shares -             |           |                                    |           |
| Denominator:  |                                     |           |                                    |           |
| Weighted-average Shares of Common Stock Outstanding:                              |                                     |           |                                    |           |
| Common Shares Issued  | 36,308                              | 35,722    | 36,107                             | 35,623    |
| Fully Vested Deferred Stock Units   | 132                                 | 100       | 120                                | 102       |
| Participating Securities  | 93                                  | 106       | 94                                 | 104       |
| Total Weighted-average Shares of Common Stock<br>Outstanding-Basic                | 36,533                              | 35,928    | 36,321                             | 35,829    |
| Effect of Dilutive Securities:  |                                     |           |                                    |           |
| Convertible Senior Notes  | 4,192                               | 4,101     | 4,166                              | 4,086     |
| Options and Stock Issuable under Employee Benefit Plans and<br>the Directors Plan | 416                                 | 507       | 436                                | 491       |
| Total Shares Diluted  | 41,141                              | 40,536    | 40,923                             | 40,406    |

The following table shows the number of stock options to purchase shares of Common Stock excluded from the computation of diluted EPS because the stock option's exercise price was greater than the average market price of the Common Stock:

|   | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |      |
|---|-------------------------------------|------|------------------------------------|------|
|   | 2010                                | 2009 | 2010                               | 2009 |
|   | -In Thousands-                      |      |                                    |      |
| Stock Options Excluded from the Diluted EPS Computation | 218                                 | 395  | 227                                | 395  |

**NOTE 12. STOCKHOLDERS EQUITY**

In August 2010, UniSource Energy declared a third quarter dividend to shareholders of 39 cents per share of UniSource Energy Common Stock. The dividend, totaling approximately \$14 million, was paid in September 2010. For the nine-month period ended September 30, 2010, dividends of \$1.17 per share or \$42 million were paid to common shareholders. In August 2009, UniSource Energy declared a third quarter dividend to shareholders of 29 cents per share of UniSource Energy Common Stock. The dividend, totaling approximately \$10 million, was paid in September 2009. For the nine-month period ended September 30, 2009, dividends of 87 cents per share or \$31 million were paid to common shareholders.

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited  
Dividends and Capital Contribution**

UniSource Energy contributed capital to TEP of \$15 million in March 2010 and \$30 million in March 2009. Millennium paid dividends which represented return of capital distributions to UniSource Energy of \$2 million in March 2010, and \$4 million in January 2010. UED paid dividends to UniSource Energy of \$9 million in February 2010, \$4 million of which represented a return of capital distribution. In April 2010, UNS Gas paid dividends of \$10 million to UniSource Energy. In August 2010, TEP paid dividends of \$30 million to UniSource Energy.

**NOTE 13. MILLENNIUM INVESTMENTS**

In the third quarter of 2010, Millennium recorded a pre-tax impairment loss on a cost method investment of \$1 million. This was a result of a new valuation and a change in the ownership percentage following a capital infusion by new investors.

In the second quarter of 2010, UniSource Energy wrote off an investment held by Millennium. The underlying investment related to a proposed Liquefied Natural Gas project which no longer appears viable. To recognize the impairment at June 30, 2010, we recorded a pre-tax loss of \$5 million. The loss is reflected in Other Expense on the UniSource Energy income pre-tax statement. Millennium has no further investment obligation related to this investment.

In the first quarter of 2010, Millennium sold a wholly-owned subsidiary. Millennium received cash of less than \$1 million, and recorded less than \$1 million of pre-tax gain included in Other Income on UniSource Energy's income statement.

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

See Note 5 for tax information related to Millennium's investments.

**NOTE 14. TRANSMISSION ASSETS DEPRECIATION**

During the fourth quarter of 2009, TEP performed an analysis of the service life and net salvage parameters of its transmission assets. As a result, new depreciation rates were implemented effective January 1, 2010. The new rates effectively extend the expected remaining service lives of TEP's transmission assets, resulting in a reduction of related depreciation expense of \$10 million for the nine months ended September 30, 2010 compared to September 30, 2009.

**NOTE 15. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

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

The FASB issued authoritative guidance for multiple deliverable revenue arrangements that provides another alternative for determining the selling price of deliverables and eliminates the residual method of allocating consideration. In addition, this pronouncement requires expanded qualitative and quantitative disclosures and is effective for revenue arrangements entered into after January 1, 2011. We are evaluating the impact of this pronouncement.



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

The FASB issued amendments that require some new disclosures and clarify some existing disclosure requirements about fair value measurements. Disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements, are effective for interim and annual reporting periods beginning January 1, 2011. We will incorporate these new disclosures in our March 31, 2011 financial statements.

**NOTE 16. SUPPLEMENTAL CASH FLOW INFORMATION**

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

|  | <b>UniSource Energy</b> |                   |
|--|-------------------------|-------------------|
|  | Nine Months Ended       |                   |
|  | September 30,           |                   |
|  | <b>2010</b>             | <b>2009</b>       |
|  | -Thousands of Dollars-  |                   |
| <b>Net Income</b>  | <b>\$ 100,395</b>       | <b>\$ 93,839</b>  |
| <b>Adjustments to Reconcile Net Income To Net Cash Flows from Operating Activities</b> |                         |                   |
| Depreciation Expense   | <b>95,773</b>           | 109,601           |
| Amortization Expense   | <b>20,797</b>           | 22,280            |
| Depreciation and Amortization Recorded to Fuel and Other O&M Expense                   | <b>4,025</b>            | 3,667             |
| Amortization of Deferred Debt-Related Costs Included in Interest Expense               | <b>2,672</b>            | 3,170             |
| Provision for Bad Debts  | <b>2,881</b>            | 2,537             |
| Deferred Income Taxes  | <b>58,970</b>           | 52,849            |
| Deferred Tax Valuation Allowance   | <b>5,702</b>            |                   |
| Pension and Postretirement Expense   | <b>14,626</b>           | 17,987            |
| Pension and Postretirement Funding   | <b>(20,927)</b>         | (23,275)          |
| Share-Based Compensation Expense   | <b>2,102</b>            | 2,120             |
| Excess Tax Benefit from Stock Options Exercised  | <b>(1,796)</b>          | (1,929)           |
| CTC Revenue Refunded   | <b>(8,152)</b>          | (9,040)           |
| Decrease to Reflect PPFAC/PGA Recovery   | <b>(35,335)</b>         | (5,083)           |
| Loss/(Gain) on Millennium's Investments  | <b>5,208</b>            | (5,979)           |
| Changes in Assets and Liabilities which Provided (Used)                                |                         |                   |
| Cash Exclusive of Changes Shown Separately   |                         |                   |
| Accounts Receivable  | <b>(35,783)</b>         | (6,655)           |
| Materials and Fuel Inventory   | <b>12,691</b>           | (32,020)          |
| Other Regulatory Assets  | <b>(4,897)</b>          | 434               |
| Accounts Payable   | <b>6,851</b>            | (6,617)           |
| Interest Accrued   | <b>(3,633)</b>          | (4,621)           |
| Income Taxes   | <b>8,911</b>            | 19,478            |
| Accrued Taxes Other than Income Taxes  | <b>18,855</b>           | 14,381            |
| Other Regulatory Liabilities   | <b>2,774</b>            | 18,929            |
| Other  | <b>(3,418)</b>          | (3,755)           |
| <b>Net Cash Flows Operating Activities</b>   | <b>\$ 249,292</b>       | <b>\$ 262,298</b> |



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

|  | <b>TEP</b>                         |                   |
|--|------------------------------------|-------------------|
|  | Nine Months Ended<br>September 30, |                   |
|  | <b>2010</b>                        | <b>2009</b>       |
|  | -Thousands of Dollars-             |                   |
| <b>Net Income</b>  | <b>\$ 96,979</b>                   | <b>\$ 81,229</b>  |
| <b>Adjustments to Reconcile Net Income To Net Cash Flows from Operating Activities</b> |                                    |                   |
| Depreciation Expense   | 74,143                             | 88,605            |
| Amortization Expense   | 23,963                             | 25,934            |
| Depreciation and Amortization Recorded to Fuel and Other O&M Expense                   | 2,837                              | 2,546             |
| Amortization of Deferred Debt-Related Costs Included in Interest Expense               | 1,534                              | 1,882             |
| Provision for Bad Debts  | 1,961                              | 1,626             |
| Deferred Income Taxes  | 49,984                             | 42,350            |
| Pension and Postretirement Expense   | 12,979                             | 16,262            |
| Pension and Postretirement Funding   | (19,174)                           | (21,793)          |
| Share-Based Compensation Expense   | 1,628                              | 1,619             |
| CTC Revenue Refunded   | (8,152)                            | (9,040)           |
| Decrease to Reflect PPFAC Recovery   | (24,098)                           | (16,898)          |
| Changes in Assets and Liabilities which Provided (Used)                                |                                    |                   |
| Cash Exclusive of Changes Shown Separately   |                                    |                   |
| Accounts Receivable  | (44,561)                           | (28,695)          |
| Materials and Fuel Inventory   | 11,889                             | (31,146)          |
| Other Regulatory Assets  | (4,566)                            | 461               |
| Accounts Payable   | 13,792                             | 5,394             |
| Interest Accrued   | 1,420                              | 488               |
| Income Taxes   | 1,950                              | 3,242             |
| Accrued Taxes Other than Income Taxes  | 17,772                             | 15,213            |
| Other Regulatory Liabilities   | 2,684                              | 17,411            |
| Other  | (1,126)                            | 784               |
| <b>Net Cash Flows Operating Activities</b>   | <b>\$ 213,838</b>                  | <b>\$ 197,474</b> |

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited**  
**NOTE 17. ACCOUNTING FOR DERIVATIVE INSTRUMENTS, TRADING ACTIVITIES AND HEDGING**  
**ACTIVITIES****RISKS AND OVERVIEW**

The three utilities are exposed to energy price risk associated with their gas and purchased power requirements, volumetric risk associated with their seasonal load and operational risk associated with their power plants, transmission and transportation systems. The energy price risk is mitigated through the PPFAC and PGA mechanisms which provide an adjustment to the three utilities' retail rates to recover the actual costs of purchased power, gas, transmission and transportation. The three utilities further reduce their energy price risk through a variety of derivative and non-derivative instruments. The objectives for entering into such contracts include: creating price stability for the three utilities; ensuring the three utilities can meet their load and reserve requirements; and reducing the three utilities exposure to price volatility that may result in delayed recovery under the PPFAC or PGA. While current procurement methodologies allow the three utilities to recover electric and gas procurement costs from customers, future regulatory structures could change, potentially impacting the recoverability of electric and gas procurement costs. See Note 2 for further information regarding regulatory matters.

We consider the effect of counterparty credit risk in determining the fair value of derivative instruments that are in a net asset position, after incorporating collateral posted by counterparties, and allocating 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 allocating the credit risk adjustment to all individual contracts. Although TEP's gains and losses on trading activities are recorded on a net basis in the income statement, we report the related cash receipts and cash payments separately in the statement of cash flows. We present cash collateral and derivative assets and liabilities, associated with the same counterparty, separately in our financial statements and we bifurcate all derivatives into their current and long-term portions on the balance sheet.

**CASH FLOW HEDGES**

TEP hedges the cash flow risk associated with unfavorable changes in the variable interest rates related to LIBOR on the Springerville Common Facilities Lease. In addition, TEP hedges the cash flow risk associated with a six-year power supply agreement using a six-year power purchase swap agreement. TEP accounts for cash flow hedges as follows:

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

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

**MARK-TO-MARKET****TEP**

TEP non-trading hedges, such as forward power purchase contracts indexed to gas, short-term forward power sales contracts, or call and put options (gas collars), that were not designated as cash flow hedges or did not qualify for the normal scope exception, are considered mark-to-market transactions. TEP hedges a portion of its monthly natural gas exposure for plant fuel, gas-indexed purchased power and spot market purchases with fixed price contracts for a maximum of three years. Unrealized gains and losses are recorded as either a regulatory asset or regulatory liability only to the extent they qualify for recovery under the PPFAC mechanism.



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

TEP enters into certain energy-related derivatives for trading purposes which are forward power purchase and sale contracts entered into purely to profit from market price changes. As unrealized gains and losses resulting from changes in the market prices of trading derivatives are not recoverable in the PPFAC, unrealized gains and losses are recorded in the income statement in Electric Wholesale Sales. The net trading activities represent a very small portion (less than 1%) of TEP's revenue from wholesale sales.

**UNS Electric**

UNS Electric enters into derivatives, such as fixed price forward power purchases, natural gas-indexed forward power purchase contracts, call and put options (gas collars) or financial gas swaps, to hedge a portion of its purchased power exposure. These contracts are considered mark-to-market transactions. As UNS Electric's PPFAC mechanism permits recovery of the prudent costs of hedging transactions, unrealized gains and losses resulting from changes in the market prices of such contracts are recorded as either regulatory assets or regulatory liabilities.

**UNS Gas**

UNS Gas enters into derivatives, such as forward gas purchases and financial gas swaps to ensure supply, create price stability and reduce exposure to natural gas price volatility that may result in delayed recovery under the PGA. Unrealized gains and losses are recorded as either a regulatory asset or regulatory liability, as the UNS Gas PGA mechanism permits the recovery of the prudent cost of hedging contracts.

**NORMAL PURCHASE AND NORMAL SALE**

TEP and UNS Electric enter into forward energy purchase and sales contracts, including call options, to support the current load forecast. When these contracts are entered into with counterparties that have generating capacity or load serving requirements, these contracts are not required to be marked to market and are accounted for on an accrual basis. UNS Gas enters into forward gas purchases, based on forecasted needs, with counterparties that can supply its physical requirements. These contracts meet the normal purchase scope exception and are not required to be marked to market. On an ongoing basis, we evaluate our counterparties for non-performance risk to ensure such risk does not impact our ability to obtain the normal scope exception.

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

At September 30, 2010 and December 31, 2009, UniSource Energy and TEP had liabilities related to their cash flow hedges of \$15 million and \$7 million, respectively. UniSource Energy and TEP had net after-tax unrealized losses on derivative activities reported in AOCI of \$3 million for the three months ended September 30, 2010 and \$2 million for the three months ended September 30, 2009. UniSource Energy and TEP had net after-tax unrealized losses on derivative activities reported in AOCI of \$8 million for the nine months ended September 30, 2010 and less than \$1 million for the nine months ended September 30, 2009.

**Regulatory Treatment of Commodity Derivatives**

UniSource Energy and TEP report unrealized gains and losses on energy contracts that are recoverable through the PPFAC or PGA on the balance sheet as a regulatory asset or a regulatory liability rather than as a component of AOCI or in the income statement. For the three months ended September 30, 2010, UniSource Energy recorded net increases to regulatory assets of \$6 million and TEP recorded net decreases to regulatory assets of \$1 million. UniSource Energy and TEP recorded net decreases of \$33 million and \$19 million, respectively for the three months ended September 30, 2009. For the nine months ended September 30, 2010, UniSource Energy recorded net increases to regulatory assets of \$10 million and TEP recorded net decreases to regulatory assets of \$4 million. UniSource Energy and TEP recorded net decreases to regulatory assets of \$23 million and \$11 million, respectively for the nine months ended September 30, 2009.



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

At September 30, 2010, UniSource Energy and TEP had liabilities of \$53 million and \$8 million, respectively, and assets of \$16 million and \$5 million, respectively, related to their energy derivatives that will be recovered through the PPFAC or PGA. At December 31, 2009, UniSource Energy and TEP had liabilities of \$34 million and \$9 million, respectively, and assets of \$7 million and \$2 million, respectively, related to their energy derivatives that will be recovered through the PPFAC or PGA.

Realized gains and losses on settled gas swaps are fully recovered through the PPFAC or PGA. For the three months ended September 30, 2010, UniSource Energy and TEP realized losses of \$8 million and \$5 million, respectively, and \$27 million and \$21 million, respectively, for the three months ended September 30, 2009. For the nine months ended September 30, 2010, UniSource Energy and TEP realized losses of \$17 million and \$8 million, respectively, and \$46 million and \$29 million, respectively, for the nine months ended September 30, 2009.

At September 30, 2010, TEP had contracts that will settle through the third quarter of 2015; UNS Electric had contracts that will settle through the fourth quarter of 2013; and UNS Gas had contracts that will settle through the third quarter of 2013.

**Other Commodity Derivatives**

UniSource Energy and TEP record realized and unrealized gains and losses on other energy contracts on a net basis in Wholesale Sales. For each three and nine month period ended September 30, 2010 and 2009, net realized and unrealized gains and losses were less than \$1 million. At September 30, 2010, TEP had no other energy contracts outstanding. At December 31, 2009, TEP had assets of \$4 million and liabilities of \$4 million related to other energy contracts. TEP's other energy contracts were with an affiliated counterparty; therefore, related assets and liabilities were eliminated in the UniSource Energy financial statements.

The settlement of forward power purchase and sales contracts that did not result in physical delivery were as follows:

|   | <b>UniSource Energy and TEP</b>     |             |                                    |             |
|---|-------------------------------------|-------------|------------------------------------|-------------|
|   | Three Months<br>Ended September 30, |             | Nine Months<br>Ended September 30, |             |
|   | <b>2010</b>                         | <b>2009</b> | <b>2010</b>                        | <b>2009</b> |
|   | -Millions of Dollars-               |             |                                    |             |
| Recorded in Wholesale Sales:  |                                     |             |                                    |             |
| Forward Power Sales   | \$ 19                               | \$ 8        | \$ 25                              | \$ 20       |
| Forward Power Purchases   | (25)                                | (7)         | (32)                               | (18)        |
| <b>Total Sales and Purchases Not Resulting in<br/>Physical Delivery</b> | <b>\$ (6)</b>                       | <b>\$ 1</b> | <b>\$ (7)</b>                      | <b>\$ 2</b> |

**DERIVATIVE VOLUMES**

At September 30, 2010, UniSource Energy and TEP had gas swaps totaling 14,833 GBtu and 6,397 GBtu, respectively, and power contracts totaling 4,646 GWh and 1,246 GWh, respectively, which were accounted for as derivatives. At December 31, 2009, UniSource Energy and TEP had gas swaps totaling 13,321 GBtu and 5,658 GBtu, respectively, and power contracts totaling 3,859 GWh and 1,247 GWh, respectively, which were accounted for as derivatives.

**CREDIT RISK ADJUSTMENT**

When the fair value of our derivative contracts is reflected as an asset, the counterparty owes us and this creates credit risk. We minimize our credit risk by: (1) entering into transactions with high-quality counterparties, (2) limiting our exposure to each counterparty, (3) monitoring the financial condition of the counterparties and (4) requiring collateral in accordance with the counterparty master agreements. Using a combination of market credit default swap data and historical recovery rates for bonds, we consider the impact of counterparty creditworthiness in determining the fair value of our derivatives as well as its possible effect on continued qualification for cash flow hedge accounting. At September 30, 2010, and at December 31, 2009, the impact of counterparty credit risk on the fair value of derivative



asset contracts was less than \$1 million.

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We also consider the impact of our own credit risk on instruments that are in a net liability position, after deducting collateral posted, using market credit default swap data and allocating the credit risk adjustment to all individual contracts in a net liability position. At September 30, 2010, and at December 31, 2009, the impact of our own credit risk was less than \$1 million.

**CONCENTRATION OF CREDIT RISK**

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

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

The following table shows the sum of the fair value of all derivative instruments under contracts with credit-risk related contingent features that are in a net liability position at September 30, 2010. It also shows cash collateral and letters of credit posted, and additional collateral to be posted if credit-risk related contingent features were triggered.

|  | TEP   | UNS<br>Gas            | UNS<br>Electric | UniSource<br>Energy |
|--|-------|-----------------------|-----------------|---------------------|
|  |       | September 30, 2010    |                 |                     |
|  |       | -Millions of Dollars- |                 |                     |
| Net Liability Position   | \$ 30 | \$ 22                 | \$ 29           | \$ 81               |
| Cash Collateral Posted   |       | 3                     |                 | 3                   |
| Letters of Credit  | 1     |                       | 18              | 19                  |
| Additional Collateral to Post if Contingent Features Triggered | 30    | 19                    | 15              | 64                  |

As of September 30, 2010, TEP had \$20 million of credit exposure to other counterparties creditworthiness related to its wholesale marketing and gas hedging activities, and UNS Electric had \$3 million related to its supply and hedging contracts. TEP had five counterparties which individually comprise greater than 10% of the total credit exposure and UNS Electric had one. At September 30, 2010, UNS Gas had immaterial exposure to other counterparties creditworthiness.

**NOTE 18. REVIEW BY INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The UniSource Energy and TEP condensed consolidated financial statements as of September 30, 2010 and for the three and nine months ended September 30, 2010 and 2009, have been reviewed by PricewaterhouseCoopers LLP, an independent registered public accounting firm. Their reports (dated October 27, 2010) are included on pages 1 and 2. The reports of PricewaterhouseCoopers LLP state that they did not audit and they do not express an opinion on that unaudited financial information. Accordingly, the degree of reliance on their reports on such information should be restricted in light of the limited nature of the review procedures applied. PricewaterhouseCoopers LLP is not subject to the liability provisions of Section 11 of the Securities Act of 1933 (the Act) for their reports on the unaudited financial information because neither of those reports is a report or a part of the registration statement prepared or certified by PricewaterhouseCoopers LLP within the meaning of Sections 7 and 11 of the Act.



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

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

- outlook and strategies;
- operating results during the third quarter and nine-months ended September 30, 2010 compared with the same periods in 2009;
- factors which affect our results and outlook;
- liquidity, capital needs, capital resources, and contractual obligations;
- dividends; and
- critical accounting estimates.

Management's Discussion and Analysis should be read in conjunction with UniSource Energy and TEP's 2009 Annual Report on Form 10-K and with the Comparative Condensed Consolidated Financial Statements, beginning on page 3, which present the results of operations for the three and nine-months ended September 30, 2010 and 2009.

Management's Discussion and Analysis explains the differences between periods for specific line items of the Comparative Condensed Consolidated Financial Statements.

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

**UNISOURCE ENERGY CONSOLIDATED**

**OVERVIEW OF CONSOLIDATED BUSINESS**

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

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

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

Millennium has existing investments in unregulated businesses that represent less than 1% of UniSource Energy's total assets as of September 30, 2010; no new investments are planned in Millennium.

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

**OUTLOOK AND STRATEGIES**

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

- Focus on the core utility businesses including: operational excellence; investing in utility rate base; customer satisfaction; community presence; and achieving constructive regulatory outcomes.

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Expand TEP and UNS Electric's portfolio of renewable energy resources and programs to meet Arizona's renewable energy standards while creating ownership opportunities for renewable energy projects that benefit customers, shareholders and the communities we serve.

Develop strategic responses to energy efficiency requirements that protect the financial stability of our utility businesses and provide benefits to our customers.

Expand TEP and UNS Electric's transmission system to meet increasing loads and provide access to renewable energy resources.

Develop strategic responses to new environmental regulation and potential new legislation, including limitations on carbon emissions. We are evaluating TEP's existing mix of generation resources and defining steps to achieve environmental objectives that provide an appropriate return on investment and are consistent with earnings growth.

Refinance expiring credit facilities and maturing long-term debt at UniSource Energy, TEP, UNS Gas and UNS Electric before the obligations expire or mature in August 2011.

**RESULTS OF OPERATIONS**

**Executive Overview**

**Seasonality of Utility Operations**

The net income and results of operations of UniSource Energy's utility businesses are seasonal in nature. TEP and UNS Electric are summer-peaking utilities and historically have recorded a majority of their net income during the second and third quarters, when hot weather drives increases in energy consumption. Energy demand from UNS Gas customers typically peaks during the winter, and that company records the majority of its net income during the first and fourth quarters.

**Third Quarter of 2010 Compared with the Third Quarter of 2009**

UniSource Energy reported net income of \$55 million in the third quarter of 2010 compared with \$58 million in the third quarter of 2009. Factors that affected earnings in the third quarter of 2010 compared with the same period in 2009 include:

- A \$6 million after-tax loss recorded at Millennium related to the write-off of deferred taxes and the impairment of investments; partially offset by
- Lower depreciation and amortization expense at TEP; and
- Operating benefits related to Springerville Unit 4.

**Nine Months Ended September 30, 2010 Compared with the Nine Months Ended September 30, 2009**

UniSource Energy reported net income of \$100 million in the first nine months of 2010 compared with \$94 million in the same period last year. Factors that contributed to the increase in UniSource Energy's net income in the first nine months of 2010 occurred primarily at TEP. These include:

- Lower depreciation and amortization expense at TEP;
- Operating benefits related to Springerville Unit 4;
- The sale of transmission capacity by TEP to the owner of Springerville Unit 4 during the first three months of 2010; and
- Lower base O&M expense due to fewer planned maintenance outages and lower pension expense; partially offset by:

- A decrease in retail margin revenues caused by weather, weak economic conditions and the implementation of energy efficiency measures; and
- Lower other income related to items recorded in the first nine months of 2009 including: interest income related to an income tax refund; and a gain recognized on company owned life insurance.

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Factors that offset the increase in TEP's net income include:

A \$9 million after-tax loss at Millennium related to the write-off of deferred taxes and the impairment of investments in the first nine months of 2010; and

A \$4 million after-tax gain related to the sale of an investment by Millennium in the first nine months of 2009.

See *Tucson Electric Power, Results of Operations* below for more information.

**Operations and Maintenance Expense**

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

|   | <b>Three Months<br/>Ended Sept. 30,</b> |             | <b>Nine Months<br/>Ended Sept. 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2010</b>                             | <b>2009</b> | <b>2010</b>                            | <b>2009</b> |
|   | <b>-Millions of Dollars-</b>            |             | <b>-Millions of Dollars-</b>           |             |
| TEP Base O&M  | \$ 53                                   | \$ 53       | \$ 163                                 | \$ 174      |
| UNS Gas Base O&M  | 6                                       | 6           | 18                                     | 18          |
| UNS Electric Base O&M   | 5                                       | 5           | 15                                     | 14          |
| Consolidating Adjustments and Other <sup>(1)</sup>                                      | (2)                                     | (2)         | (6)                                    | (5)         |
| UniSource Energy Base O&M   | 62                                      | 62          | 190                                    | 201         |
| Reimbursed Expenses Related to Springerville<br>Units 3 and 4                           | 14                                      | 12          | 41                                     | 29          |
| Expenses Related to Customer-Funded Renewable<br>Energy and DSM Programs <sup>(2)</sup> | 13                                      | 6           | 28                                     | 13          |
| Total UniSource Energy O&M  | \$ 89                                   | \$ 80       | \$ 259                                 | \$ 243      |

(1) Includes Millennium, UED and parent company O&M, and inter-company eliminations.

(2) Corresponding amounts are charged to customers and are recorded in electric retail revenues.

**CONTRIBUTION BY BUSINESS SEGMENT**

The table below shows the contributions to our consolidated after-tax earnings by our three business segments, as well as Other Net Income (Loss).

|  | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|--|---|-------------|--|-------------|
|  | <b>2010</b>                                 | <b>2009</b> | <b>2010</b>                                | <b>2009</b> |
|  | <b>-Millions of Dollars-</b>                |             | <b>-Millions of Dollars-</b>               |             |

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|                         |    |     |    |     |    |      |    |    |
|-------------------------|----|-----|----|-----|----|------|----|----|
| TEP                     | \$ | 59  | \$ | 55  | \$ | 97   | \$ | 81 |
| UNS Gas                 |    | (1) |    | (1) |    | 5    |    | 4  |
| UNS Electric            |    | 3   |    | 4   |    | 8    |    | 6  |
| Other <sup>(1)</sup>    |    | (6) |    |     |    | (10) |    | 3  |
| Consolidated Net Income | \$ | 55  | \$ | 58  | \$ | 100  | \$ | 94 |

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

**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES****Liquidity**

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

|                                     | <b>Cash and<br/>Cash<br/>Equivalents</b> | <b>Borrowings<br/>under<br/>Revolving<br/>Credit<br/>Facility<sup>(1)</sup></b> | <b>Amount<br/>Available<br/>under<br/>Revolving<br/>Credit Facility</b> |
|-------------------------------------|--|---|---|
| <b>Balances at October 15, 2010</b> |  |   |   |
|                                     |  | -Millions of Dollars-   |   |
| UniSource Energy stand-alone        | \$ 2                                     | \$ 30   | \$ 40   |
| TEP                                 | 42                                       | 1   | 149   |
| UNS Gas                             | 25                                       |   | 45 <sup>(2)</sup>   |
| UNS Electric                        | 15                                       | 18  | 27 <sup>(2)</sup>   |
| Other                               | 7 <sup>(3)</sup>                         | N/A   | N/A   |
| <b>Total</b>                        | <b>\$ 91</b>                             |   |   |

(1) Includes letters of credit issued under revolving credit facilities.

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

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

**Short-term Investments**

We have a short-term investment policy which governs the investment of excess cash balances by UniSource Energy and its subsidiaries. This policy is reviewed periodically in response to market conditions to adjust, if necessary, the maturities and concentrations by investment type and issuer in the investment portfolio. As of September 30, 2010,



UniSource Energy's short-term investments consisted of highly-rated and liquid money market funds, certificates of deposit and commercial paper. These short-term investments are classified as Cash and Cash Equivalents on the Balance Sheet.

Access to Revolving Credit Facilities

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

UniSource Energy and its subsidiaries believe that they have sufficient liquidity under their revolving credit facilities to meet their short-term working capital needs and to provide credit enhancement as may be required under their respective energy procurement and hedging agreements. See *Item 3. Quantitative and Qualitative Disclosures about Market Risk, Credit Risk*, below.

**Table of Contents****Refinancings**

UniSource Energy and its subsidiaries have \$621 million of credit facilities, which include revolvers that expire in August 2011. We are in the process of refinancing the UniSource Energy, TEP, UNS Gas and UNS Electric credit facilities and expect the transactions to be completed by the end of 2010. Based on current market conditions, the associated interest rate spreads are expected to increase approximately 150 to 175 basis points over current levels. Also in August 2011, UNS Gas has \$50 million of unsecured notes that mature. We intend to refinance the \$50 million prior to its maturity.

See: *UniSource Energy Credit Agreement*, below; *Tucson Electric Power, Liquidity and Capital Resources, TEP Credit Agreement*, below; and *UNS Gas, Liquidity and Capital Resources, UNS Gas/UNS Electric Revolver*, below for more information.

**Executive Overview    UniSource Energy Consolidated Cash Flows****Nine Months Ended September 30,**

**2010                      2009**  
-Millions of Dollars-

Cash provided by (used in):

|                      |            |            |
|----------------------|------------|------------|
| Operating Activities | \$     249 | \$     262 |
| Investing Activities | (227)      | (248)      |
| Financing Activities | (32)       | (6)        |

**Operating Activities**

In the first nine months of 2010, net cash flows from operating activities were \$13 million lower than the same period last year due to: an \$8 million increase in total taxes paid in the first nine months of 2010 compared with the same period last year; a \$4 million decrease in interest received in the first nine months of 2010 due in part to lower balances of investments in lease debt by TEP; and \$17 million of income tax refunds received in 2009; partially offset by a \$16 million increase in proceeds from the operation of Springerville Units 3 and 4.

**Investing Activities**

Net cash flows used for investing activities decreased by \$21 million in the first nine months of 2010 compared with the same period last year. The decrease resulted primarily from a \$13 million increase in lease debt principal received and a \$4 million decrease in insurance proceeds in the first nine months of 2010 compared with the same period last year and activities that took place in the first nine months of 2009 including: a \$31 million investment in lease debt; and \$5 million in proceeds from the sale of an interest in a Millennium investment.

**Capital Expenditures**

In the first nine months of 2010, UniSource Energy's capital expenditures, including the purchase of Sundt Unit 4 by TEP, were \$252 million, a \$15 million increase compared with the first nine months of 2009. Excluding TEP's purchase of Sundt Unit 4, UniSource Energy's capital expenditures were \$37 million below the first nine months of 2009 due primarily to a decline in customer growth in our utility service areas resulting from regional economic weakness. The purchase of Sundt Unit 4 is included in our estimated capital expenditures for 2010.

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|                               | Actual<br>Year-to-Date<br>Sept. 30,<br>2010<br>-Millions of Dollars- | Actual<br>Year-to-Date<br>Sept. 30,<br>2009<br>-Millions of Dollars- | Estimate<br>Full Year<br>2010<br>-Millions of Dollars- | Actual<br>Full Year<br>2009<br>-Millions of Dollars- |
|-------------------------------|--|--|--|--|
| TEP                           | \$ 218   | \$ 195   | \$ 276   | \$ 235   |
| UNS Gas                       | 7  | 11   | 12   | 14   |
| UNS Electric                  | 17   | 23   | 24   | 28   |
| Other                         | 10   | 8  | 16   | 10   |
| UniSource Energy Consolidated | \$ 252   | \$ 237   | \$ 328   | \$ 287   |

**Financing Activities**

Net cash flows used for financing activities were \$26 million higher in the first nine months of 2010 compared with the same period last year due primarily to: a \$32 million increase in payments on TEP's capital lease obligations; an \$11 million increase in dividends paid to shareholders; and a \$7 million decrease in debt proceeds, net of debt repayments and issuances or retirement costs. Those activities were partially offset by an increase in revolving credit facility borrowings of \$14 million, net of repayments, and a \$7 million increase in proceeds from exercised stock options.

**UniSource Energy Credit Agreement**

The UniSource Credit Agreement, which expires in August 2011, consists of a \$30 million amortizing term loan facility and a \$70 million revolving credit facility. Principal payments of \$1.5 million on the outstanding term loan are due quarterly, with the balance due at maturity. At September 30, 2010, there was \$5 million outstanding under the term loan facility and \$29 million outstanding under the UniSource Energy revolving credit facility at a weighted average interest rate of 1.51%. We have the option of paying interest on the term loan and on borrowings under the revolving credit facility at adjusted LIBOR plus 1.25% or the sum of the greater of the federal funds rate plus 0.5% or the agent bank's reference rate and 0.25%.

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

As of September 30, 2010, we were in compliance with the terms of the UniSource Credit Agreement.

If an event of default occurs, the UniSource Credit Agreement may become immediately due and payable. An event of default includes failure to make required payments under the UniSource Credit Agreement, failure of UniSource Energy or certain subsidiaries to make payments or default on debt greater than \$20 million, or certain bankruptcy events at UniSource Energy or certain subsidiaries. For information about refinancing the UniSource Credit Agreement see *UniSource Energy Consolidated, Liquidity and Capital Resources, Liquidity*, above.

**Interest Rate Risk**

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

**Convertible Senior Notes**

UniSource Energy has outstanding \$150 million of 4.50% Convertible Senior Notes due 2035. Each \$1,000 of Convertible Senior Notes is convertible into 27.95 shares of our Common Stock at any time, representing a conversion price of \$35.78 per share of our Common Stock, subject to adjustments. The closing price of UniSource Energy's Common Stock was \$34.27 on October 15, 2010.



**Table of Contents****Guarantees**

In the normal course of business, UniSource Energy and certain subsidiaries enter into various agreements providing financial or performance assurance to third parties on behalf of certain subsidiaries. We enter into these agreements primarily to support or enhance the creditworthiness of a subsidiary on a stand-alone basis. The most significant of these guarantees at September 30, 2010 were:

UES guarantee of \$100 million senior unsecured notes issued by UNS Gas and \$100 million senior unsecured notes issued by UNS Electric;

UES guarantee of the \$60 million UNS Gas/UNS Electric Revolver;

UniSource Energy's guarantee of approximately \$2 million in building lease payments for UNS Gas; and

UniSource Energy's guarantee of the \$32 million of outstanding loans under the UED Credit Agreement.

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

We believe that the likelihood that UniSource Energy or UES would be required to perform or otherwise incur any significant losses associated with any of these guarantees is remote.

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

**Contractual Obligations**

There have been no significant changes in our contractual obligations or other commercial commitments from those reported in our 2009 Annual Report on Form 10-K, other than the following entered into in 2010:

| Payment Due in Years<br>Ending December 31,      | 2010                    | 2011  | 2012  | 2013 | 2014 | 2015<br>and<br>after | Total  |
|--|-------------------------|-------|-------|------|------|----------------------|--------|
|  | - Millions of Dollars - |       |       |      |      |                      |        |
| Long-Term Debt <sup>(1)</sup>                    | \$ 32                   | \$ 6  | \$ 24 | \$   | \$   | \$                   | \$ 62  |
| Purchase Obligations:                            |                         |       |       |      |      |                      |        |
| Fuel   |                         | 4     | 4     | 2    |      |                      | 10     |
| Purchased Power                                  |                         | 40    | 7     |      |      |                      | 47     |
| Building Commitments                             | 14                      | 4     |       |      |      |                      | 18     |
| Solar Installation Commitments                   | 4                       | 2     |       |      |      |                      | 6      |
| Total Additional Contractual Cash<br>Obligations | \$ 50                   | \$ 56 | \$ 35 | \$ 2 | \$   | \$                   | \$ 143 |

(1) In February 2010, UED amended the UED Credit Agreement to extend the termination date by two years to March 2012 and to increase borrowings by

\$9 million. In March 2010, TEP entered into an 18-month, \$30 million term loan facility. TEP repaid the term loan in October 2010.

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

The following table shows the dividends declared to UniSource Energy shareholders for 2010:

| <b>Declaration Date</b> | <b>Record Date</b> | <b>Payment Date</b> | <b>Dividend Amount<br/>Per Share<br/>of Common Stock</b> |      |
|-------------------------|--------------------|---------------------|--|------|
| February 12, 2010       | February 23, 2010  | March 8, 2010       | \$   | 0.39 |
| May 5, 2010             | May 17, 2010       | June 4, 2010        | \$   | 0.39 |
| August 5, 2010          | August 19, 2010    | September 2, 2010   | \$   | 0.39 |

**Income Tax Position**

At September 30, 2010, UniSource Energy had federal AMT credit carryforwards of \$41 million, including \$24 million for TEP, which do not expire. UniSource Energy has a capital loss carryforward of \$8 million which expires on December 31, 2015. As of September 30, 2010, a \$3 million valuation allowance has been recorded against the deferred tax asset. See *Financial Statements Note 5. Income Taxes*, for more information.

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

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

TEP recorded net income of \$59 million in the third quarter of 2010 compared with net income of \$55 million in the same period in 2009. The improvement is due primarily to: a decrease in depreciation and amortization expense due to lower depreciation rates on TEP's transmission assets; lower capital lease amortization resulting from a decline in outstanding capital lease obligations; and benefits related to Springerville Unit 4, which began commercial operations in December 2009.

**Third Quarter of 2010 Compared with the Third Quarter of 2009**

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

A \$3 million decrease in depreciation expense due to lower depreciation rates on TEP's transmission assets, a lengthened depreciation period for leasehold improvements at Sundt Unit 4, partially offset by depreciation related to an increase in plant-in-service;

a \$1 million decrease in amortization expense related to lower capital lease amortization; and

\$3 million of pre-tax benefit recognized by TEP related to Springerville Unit 4 for operating fees and contributions toward common facility costs received from the owner of Springerville Unit 4. Springerville Unit 4 started commercial operation in December 2009.

These factors were partially offset by:

a \$1 million decrease in total retail margin revenues due primarily to a 5% decrease in cooling degree days compared with the same period last year.

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**Nine Months Ended September 30, 2010 Compared with the Nine Months Ended September 30, 2009**

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

An \$11 million decrease in base O&M expense, which excludes costs directly offset by customer surcharges for renewable energy and demand side management programs and third party reimbursements, resulting primarily from lower generating plant maintenance expense and a \$3 million decrease in pension and post retirement medical expense. See *Operations and Maintenance Expense*, below;

\$9 million of pre-tax benefits recognized by TEP related to Springerville Unit 4 for operating fees and contributions toward common facility costs received from the owner of Springerville Unit 4. Springerville Unit 4 started commercial operation in December 2009;

a \$7 million decrease in depreciation expense due to lower depreciation rates on TEP's transmission assets and a lengthened depreciation period for leasehold improvements at Sundt Unit 4, partially offset by depreciation related to an increase in plant-in-service. The decrease excludes a \$7 million adjustment that increased depreciation expense in the second quarter of 2009, related to a change in accounting for TEP's investment in Springerville Unit 1 lease equity;

a \$5 million decrease in amortization expense due to a decline in the balance of capital lease obligations. The decrease excludes a \$3 million adjustment that decreased amortization expense made in the second quarter of 2009, related to a change in accounting for TEP's investment in Springerville Unit 1 lease equity;

a \$3 million increase in wholesale transmission revenues as TEP temporarily provided transmission capacity for Springerville Unit 4 during the first quarter of 2010; and

a \$1 million increase in long-term wholesale margin revenues due primarily to an increase in sales volumes to one of TEP's long-term wholesale customers.

These factors were partially offset by:

a \$5 million decrease in total retail margin revenues. Weather, the implementation of energy efficiency measures and weak economic conditions contributed to a 1% decrease in kWh sales compared with the first nine months of 2009. Cooling degree days during the first nine months of 2010 were 5% below the same period last year;

a \$7 million decrease in total other income due in part to interest related to an income tax refund received in the second quarter of last year and a decline in gains recognized on company owned life insurance. The decrease excludes a \$3 million adjustment that increased other income in the second quarter of 2009, related to a change in accounting for TEP's investment in Springerville Unit 1 lease equity; and

a \$3 million provision for wholesale refunds in the first quarter of 2010 resulting from the settlement of disputes related to wholesale sales to the California Power Exchange in 2000 and 2001.



**Table of Contents****Retail Sales and Revenues**

| Three Months Ended September 30,<br>Energy Sales, kWh (in millions) | 2010          | 2009          | Increase (Decrease) |               |
|---|---------------|---------------|---------------------|---------------|
|   |               |               | Amount              | Percent*      |
| <b>Electric Retail Sales:</b>                                       |               |               |                     |               |
| Residential   | 1,445         | 1,453         | (8)                 | (0.6%)        |
| Commercial  | 612           | 619           | (7)                 | (1.1%)        |
| Industrial  | 630           | 628           | 2                   | 0.3%          |
| Mining  | 274           | 269           | 5                   | 2.0%          |
| Public Authorities  | 65            | 67            | (2)                 | (2.3%)        |
| <b>Total Electric Retail Sales</b>                                  | <b>3,026</b>  | <b>3,036</b>  | <b>(10)</b>         | <b>(0.3%)</b> |
| <b>Retail Margin Revenues (in millions):</b>                        |               |               |                     |               |
| Residential   | \$ 97         | \$ 97         | \$                  | (0.7%)        |
| Commercial  | 51            | 52            | (1)                 | (0.9%)        |
| Industrial  | 29            | 29            |                     | (1.7%)        |
| Mining  | 8             | 8             |                     | 4.7%          |
| Public Authorities  | 3             | 3             |                     | (1.2%)        |
| <b>Total Retail Margin Revenues</b>                                 | <b>\$ 188</b> | <b>\$ 189</b> | <b>\$ (1)</b>       | <b>(0.7%)</b> |
| <b>Retail Fuel Revenues</b>   | <b>100</b>    | <b>103</b>    | <b>(3)</b>          | <b>(2.7%)</b> |
| <b>RES &amp; DSM Revenues</b>                                       | <b>12</b>     | <b>5</b>      | <b>7</b>            | <b>NM</b>     |
| <b>Total Retail Revenues</b>  | <b>\$ 300</b> | <b>\$ 297</b> | <b>\$ 3</b>         | <b>1.0%</b>   |
| <b>Avg. Retail Margin Rate (cents / kWh):</b>                       |               |               |                     |               |
| Residential   | 6.67          | 6.67          |                     | (0.1%)        |
| Commercial  | 8.35          | 8.34          | 0.01                | 0.2%          |
| Industrial  | 4.57          | 4.67          | (0.10)              | (2.0%)        |
| Mining  | 2.95          | 2.87          | 0.08                | 2.7%          |
| Public Authorities  | 5.25          | 5.19          | 0.06                | 1.2%          |
| <b>Avg. Retail Margin Rate</b>                                      | <b>6.20</b>   | <b>6.23</b>   | <b>(0.03)</b>       | <b>(0.4%)</b> |
| <b>Avg. PPFAC Rate</b>  | <b>3.33</b>   | <b>3.41</b>   | <b>(0.08)</b>       | <b>(2.4%)</b> |
| <b>Avg. RES &amp; DSM Rate</b>                                      | <b>0.39</b>   | <b>0.16</b>   | <b>0.23</b>         | <b>NM</b>     |
| <b>Total Avg. Retail Rate</b>                                       | <b>9.92</b>   | <b>9.80</b>   | <b>0.12</b>         | <b>1.3%</b>   |
|   | <b>2010</b>   | <b>2009</b>   |                     |               |
| <b>Weather Data:</b>  |               |               |                     |               |
| <b>Cooling Degree Days</b>  |               |               |                     |               |
| Three Months Ended September 30,                                    | 1,096         | 1,155         | (59)                | (5.1%)        |
| 10-Year Average   | 978           | 970           |                     |               |

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

Residential

Residential kWh sales were 0.6% lower in the third quarter of 2010, resulting in a decrease in residential margin revenues of less than \$1 million. The decline in residential kWh sales can be attributed primarily to a 5.1% decrease in cooling degree days compared with the third quarter of 2009.

Commercial

Commercial kWh sales decreased by 1.1% compared with the third quarter of 2009. A decline in cooling degree days and weak economic conditions contributed to the sales decline. The lower sales volumes led to a decline in commercial margin revenues of \$1 million.

**Table of Contents****Industrial**

Industrial kWh sales increased by 0.3% compared with the third quarter of 2009. Margin revenues from industrial customers in the third quarter of 2010 decreased slightly compared with the same period last year due to changing usage patterns which reduced demand charges.

**Mining**

Higher copper prices led to increased mining activity and a 2.0% increase in sales volumes in the third quarter of 2010 compared with the same period last year. Margin revenues from mining customers in the third quarter of 2010 rose slightly compared with the same period last year due to changing usage patterns which increased demand charges.

**Wholesale Sales and Revenues**

| <b>Three Months Ended September 30,<br/>Long-Term Wholesale Contracts</b> | <b>2010</b> | <b>2009</b> | <b>Increase (Decrease)</b> |                 |
|---|-------------|-------------|----------------------------|-----------------|
|   |             |             | <b>Amount</b>              | <b>Percent*</b> |
| kWh Sales (Millions)  | 224         | 126         | 98                         | 77.8%           |
| Revenues (Millions)   | \$ 14       | \$ 10       | \$ 4                       | 33.2%           |

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

**Long-Term Wholesale and Transmission Revenues**

Revenues from long-term wholesale contracts increased by \$4 million compared with the third quarter of 2009, due primarily to an increase in kWh sales to SRP, which nearly doubled compared with the third quarter of 2009.

**Short-Term Wholesale and Trading Revenues**

In the third quarters of 2010 and 2009, TEP's short-term wholesale and trading revenues were \$15 million and \$22 million, respectively. All of the revenues from short-term wholesale sales and 10% of the profits from wholesale trading activity are credited to fuel and purchased power costs eligible for recovery in the PPFAC.

**Table of Contents****Retail Sales and Revenues**

| Nine Months Ended September 30,<br>Energy Sales, kWh (in millions) | 2010          | 2009          | Increase (Decrease) |               |
|--|---------------|---------------|---------------------|---------------|
|  |               |               | Amount              | Percent*      |
| <b>Electric Retail Sales:</b>                                      |               |               |                     |               |
| Residential  | 3,109         | 3,129         | (20)                | (0.6%)        |
| Commercial   | 1,516         | 1,545         | (29)                | (1.9%)        |
| Industrial   | 1,639         | 1,667         | (28)                | (1.6%)        |
| Mining   | 807           | 793           | 14                  | 1.7%          |
| Public Authorities   | 178           | 188           | (10)                | (5.5%)        |
| <b>Total Electric Retail Sales</b>                                 | <b>7,249</b>  | <b>7,322</b>  | <b>(73)</b>         | <b>(1.0%)</b> |
| <b>Retail Margin Revenues (in millions):</b>                       |               |               |                     |               |
| Residential  | \$ 203        | \$ 204        | \$ (1)              | (0.6%)        |
| Commercial   | 124           | 125           | (1)                 | (0.9%)        |
| Industrial   | 74            | 77            | (3)                 | (4.4%)        |
| Mining   | 23            | 23            |                     | 2.8%          |
| Public Authorities   | 9             | 9             |                     | (3.7%)        |
| <b>Total Retail Margin Revenues</b>                                | <b>\$ 433</b> | <b>\$ 438</b> | <b>\$ (5)</b>       | <b>(1.3%)</b> |
| <b>Retail Fuel Revenues</b>  | <b>222</b>    | <b>227</b>    | <b>(5)</b>          | <b>(1.7%)</b> |
| <b>RES &amp; DSM Revenues</b>                                      | <b>30</b>     | <b>10</b>     | <b>20</b>           | <b>NM</b>     |
| <b>Total Retail Revenues</b>                                       | <b>\$ 685</b> | <b>\$ 675</b> | <b>\$ 10</b>        | <b>1.5%</b>   |
| <b>Avg. Retail Margin Rate (cents / kWh):</b>                      |               |               |                     |               |
| Residential  | 6.53          | 6.52          | 0.01                | 0.1%          |
| Commercial   | 8.14          | 8.07          | 0.07                | 0.9%          |
| Industrial   | 4.52          | 4.65          | (0.13)              | (2.8%)        |
| Mining   | 2.88          | 2.84          | 0.04                | 1.1%          |
| Public Authorities   | 5.10          | 5.01          | 0.09                | 1.8%          |
| <b>Avg. Retail Margin Rate</b>                                     | <b>5.97</b>   | <b>5.99</b>   | <b>(0.02)</b>       | <b>(0.3%)</b> |
| <b>Avg. PPFAC Rate</b>   | <b>3.07</b>   | <b>3.10</b>   | <b>(0.03)</b>       | <b>(0.7%)</b> |
| <b>Avg. RES &amp; DSM Rate</b>                                     | <b>0.41</b>   | <b>0.14</b>   | <b>0.27</b>         | <b>NM</b>     |
| <b>Total Avg. Retail Rate</b>                                      | <b>9.45</b>   | <b>9.23</b>   | <b>0.22</b>         | <b>2.6%</b>   |
|  | <b>2010</b>   | <b>2009</b>   |                     |               |
| <b>Weather Data:</b>   |               |               |                     |               |
| <b>Cooling Degree Days</b>   |               |               |                     |               |
| Nine Months Ended September 30,                                    | 1,491         | 1,571         | (80)                | (5.1%)        |
| 10-Year Average  | 1,433         | 1,434         |                     |               |

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

Residential

Residential kWh sales were 0.6% lower in first nine months of 2010, which led to a decrease in residential margin revenues of \$1 million compared with the same period last year. Weather, local economic conditions and energy efficiency measures influence residential energy sales volumes. Cooling degree days were 5.1% below the first nine months of 2009.

Commercial and Industrial

Commercial and industrial kWh sales were lower by 1.9% and 1.6%, respectively, in the first nine months of 2010 compared with the same period last year due primarily to weak economic conditions. In addition, a decrease in cooling degree days during the third quarter of 2010 negatively impacted commercial kWh sales. The decrease in sales volumes led to declines in commercial and industrial margin revenues of \$1 million and \$3 million, respectively.

**Table of Contents****Mining**

Higher copper prices led to increased mining activity and a 1.7% increase in sales volumes and an increase in margin revenues of less than \$1 million in the first nine months of 2010 compared with the same period last year.

**Wholesale Sales and Revenues**

| Nine Months Ended September 30,      | 2010  | 2009  | Increase (Decrease) |          |
|--------------------------------------|-------|-------|---------------------|----------|
|                                      |       |       | Amount              | Percent* |
| <b>Long-Term Wholesale Contracts</b> |       |       |                     |          |
| kWh Sales (Millions)                 | 727   | 566   | 161                 | 28.4%    |
| Revenues (Millions)                  | \$ 42 | \$ 35 | \$ 7                | 20.5%    |

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

**Long-Term Wholesale and Transmission Revenues**

Revenues from long-term wholesale contracts increased by \$7 million in the first nine months of 2010 compared with the first nine months of 2009, due to a 28.4% increase in kWh sales. The increase in sales volumes and revenues is due to higher kWh sales to TEP's two primary long-term wholesale customers, SRP and Navajo Tribal Utility Authority (NTUA). The margin on TEP's long-term wholesale sales in the first nine months of 2010 and 2009 was \$20 million and \$19 million, respectively. The increase in margin in the first nine months of 2010 is due primarily to a 35% increase in sales volumes to NTUA. During 2009, NTUA received a greater allotment of federal hydro power as hydro conditions in the Colorado River basin were above normal, which negatively impacted TEP's sales volumes to NTUA.

Wholesale transmission revenues in the first nine months of 2010 increased by \$4 million as TEP temporarily provided transmission capacity to SRP for Springerville Unit 4. TEP does not expect transmission revenue to remain at this level for the remainder of 2010.

In April 2010, TEP settled all remaining claims arising out of certain of its transactions with the California Power Exchange (CPX) and the California Independent System Operator (CISO) during the California energy crisis of 2000 and 2001. As a result of this settlement, TEP recorded a \$3 million pre-tax charge against income in the first quarter of 2010. See Financial Statements *Note 6. Commitments and Contingencies*.

**Short-Term Wholesale and Trading Revenues**

In the first nine months of 2010 and 2009, TEP's short-term wholesale and trading revenues were \$44 million and \$59 million, respectively. All of the revenues from short-term wholesale sales and 10% of the profits from wholesale trading activity are credited to fuel and purchased power costs eligible for recovery in the PPFA.

**Other Revenues**

|   | 3 Months Ended<br>September 30, |       | 9 Months Ended<br>September 30, |       |
|---|---------------------------------|-------|---------------------------------|-------|
|   | 2010                            | 2009  | 2010                            | 2009  |
|   | -Millions of Dollars-           |       | -Millions of Dollars-           |       |
| <b>Revenue related to Springerville Units 3 and 4</b> | \$ 22                           | \$ 16 | \$ 65                           | \$ 43 |
| <b>Other Revenue</b>                                  | 6                               | 6     | 16                              | 16    |
| <b>Total Other Revenue</b>                            | \$ 28                           | \$ 22 | \$ 81                           | \$ 59 |



**Table of Contents****Fuel and Purchased Power Expense**

| <b>TEP</b><br><b>Three Months Ended September 30,</b> | <b>Generation and<br/>Purchased Power</b> |             | <b>Expense</b>        |             |
|---|---|-------------|-----------------------|-------------|
|   | <b>2010</b>                               | <b>2009</b> | <b>2010</b>           | <b>2009</b> |
|   | -Millions of kWh-                         |             | -Millions of Dollars- |             |
| Coal-Fired Generation                                 | 2,639                                     | 2,452       | \$ 59                 | \$ 51       |
| Gas-Fired Generation                                  | 383                                       | 436         | 25                    | 40          |
| Renewable Generation                                  | 6   | 6           |                       |             |
| Total Generation <sup>(1)</sup>                       | 3,028                                     | 2,894       | 84                    | 91          |
| Total Purchased Power                                 | 1,028                                     | 1,304       | 48                    | 53          |
| Transmission  |   |             | 1                     | 1           |
| Increase (Decrease) to Reflect PPFAC Recovery         |   |             | (13)                  | (13)        |
| Total Resources                                       | 4,056                                     | 4,198       | \$ 120                | \$ 132      |
| Less Line Losses and Company Use                      | (735)                                     | (544)       |                       |             |
| Total Energy Sold                                     | 3,321                                     | 3,654       |                       |             |

(1) Generation expense in the third quarters of 2010 and 2009 excludes \$2 million and \$1 million, respectively, related to Springerville Units 3 and 4; these expenses were reimbursed by Tri-State and SRP and recorded in Other Revenue.

| <b>TEP</b><br><b>Nine Months Ended September 30,</b> | <b>Generation and<br/>Purchased Power</b> |             | <b>Expense</b>        |             |
|--|---|-------------|-----------------------|-------------|
|  | <b>2010</b>                               | <b>2009</b> | <b>2010</b>           | <b>2009</b> |
|  | -Millions of kWh-                         |             | -Millions of Dollars- |             |
| Coal-Fired Generation                                | 6,950                                     | 6,692       | \$ 160                | \$ 140      |
| Gas-Fired Generation                                 | 768                                       | 829         | 46                    | 66          |
| Renewable Generation                                 | 19  | 17          |                       |             |
| Total Generation <sup>(1)</sup>                      | 7,737                                     | 7,538       | 206                   | 206         |



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|   |         |         |        |        |
|---|---------|---------|--------|--------|
| Total Purchased Power                         | 2,343   | 3,186   | 104    | 112    |
| Transmission                                  |         |         | 3      | 2      |
| Increase (Decrease) to Reflect PPFAC Recovery |         |         | (24)   | (17)   |
| Total Resources                               | 10,080  | 10,724  | \$ 289 | \$ 303 |
| Less Line Losses and Company Use              | (1,274) | (1,340) |        |        |
| Total Energy Sold                             | 8,806   | 9,384   |        |        |

- (1) Generation expense in the first nine months of 2010 and 2009 excludes \$5 million and \$3 million, respectively, related to Springerville Units 3 and 4; these expenses were reimbursed by Tri-State and SRP and recorded in Other Revenue.

Generating Output

Coal-related fuel expense in the third quarter and first nine months of 2010 increased compared with the same periods last year due primarily to the switching of fuel at Sundt Unit 4 from natural gas to coal, while gas-related fuel expense decreased in both periods for the same reason.

Purchased Power

Purchased power volumes and expense during the third quarter and first nine months of 2010 were lower than the same periods last year due to a decrease in short-term wholesale sales activity, an increase in coal-fired generating output and a decline in retail sales volumes.

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

|                 | <b>Three Months</b>        |             | <b>Nine Months</b>         |             |
|-----------------|----------------------------|-------------|----------------------------|-------------|
|                 | <b>Ended September 30,</b> |             | <b>Ended September 30,</b> |             |
|                 | <b>2010</b>                | <b>2009</b> | <b>2010</b>                | <b>2009</b> |
|                 | -cents per                 |             | -cents per                 |             |
|                 | kWh generated-             |             | kWh generated-             |             |
| Coal            | 2.25                       | 2.09        | 2.30                       | 2.08        |
| Gas             | 6.39                       | 9.16        | 6.00                       | 7.99        |
| Purchased Power | 4.66                       | 4.06        | 4.43                       | 3.53        |

**Market Prices**

As a participant in the Western U.S. wholesale power markets, TEP is directly and indirectly affected by changes in market conditions. The average market price for around-the-clock energy based on the Dow Jones Palo Verde Index was 21% higher in the third quarter of 2010 and 25% higher in the first nine months of 2010 compared with the same periods last year. The average price for natural gas based on the Permian Index was 32% higher than the third quarter of 2009 and 40% higher in the first nine months of 2010 compared with the same period in 2009. We cannot predict whether changes in various factors that influence demand and supply will cause prices to change for the remainder of 2010.

**Average Market Price for Around-the-Clock Energy**

|                                      | <b>\$/MWh</b> |
|--------------------------------------|---------------|
| Quarter ended September 30, 2010     | \$ 35         |
| Quarter ended September 30, 2009     | 29            |
| Nine months ended September 30, 2010 | \$ 35         |
| Nine months ended September 30, 2009 | 28            |

**Average Market Price for Natural Gas**

|                                      | <b>\$/MMBtu</b> |
|--------------------------------------|-----------------|
| Quarter ended September 30, 2010     | \$ 3.94         |
| Quarter ended September 30, 2009     | \$ 2.98         |
| Nine months ended September 30, 2010 | \$ 4.33         |
| Nine months ended September 30, 2009 | \$ 3.10         |

**Operations and Maintenance Expense**

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

|  | <b>Three Months</b>        |             | <b>Nine Months</b>         |             |
|--|----------------------------|-------------|----------------------------|-------------|
|  | <b>Ended September 30,</b> |             | <b>Ended September 30,</b> |             |
|  | <b>2010</b>                | <b>2009</b> | <b>2010</b>                | <b>2009</b> |
|  | -Millions of Dollars-      |             | -Millions of Dollars-      |             |
| Base O&M   | \$ 53                      | \$ 53       | \$ 163                     | \$ 174      |
| Reimbursed Expenses Related to Springerville Units 3 and 4                           | 14                         | 12          | 41                         | 29          |
| Expenses Related to Customer-Funded Renewable Energy and DSM Programs <sup>(1)</sup> | 9                          | 4           | 20                         | 10          |
| Total O&M  | \$ 76                      | \$ 69       | \$ 224                     | \$ 213      |

- (1) Corresponding amounts are charged to customers and are recorded in electric retail revenues.

**Table of Contents****FACTORS AFFECTING RESULTS OF OPERATIONS****Springerville Units 3 and 4**

TEP operates Springerville Units 3 and 4 on behalf of Tri-State and SRP, and receives annual benefits in the form of rental payments and other fees and cost savings. TEP recorded pre-tax benefits of \$6 million in the third quarter and \$18 million in the first nine months of 2010. In 2009, TEP recorded pre-tax benefits in the third quarter and the first nine months of \$3 million and \$9 million, respectively. The increase is primarily due to the start of commercial operation of Springerville Unit 4 in December 2009.

**Depreciation**

In the fourth quarter of 2009, TEP completed an updated depreciation study which indicated that its transmission assets' depreciable lives should be extended. As a result, TEP adopted new transmission depreciation rates effective January 2010 which will have the effect of reducing transmission-related depreciation expense by approximately \$14 million in 2010.

For the third quarter of 2010, total depreciation expense, which includes higher depreciation expense for new plant in service, was \$25 million compared with \$28 million in the same period last year. In the first nine months of 2010, total depreciation expense was \$74 million compared with \$89 million in the same period last year. Depreciation expense for the first nine months of 2009 excludes a \$7 million adjustment that increased depreciation expense in the second quarter of 2009, related to a change in accounting for TEP's investment in Springerville Unit 1 lease equity.

**Sundt Unit 4**

Until March 2010, Sundt Unit 4 was leased by TEP with a lease term expiration of January 2011. In March 2010, TEP purchased 100% of the equity interest in Sundt Unit 4 from the equity owner for approximately \$52 million. In April 2010, TEP redeemed the outstanding Sundt Unit 4 lease debt of \$5 million, terminated the lease agreement and caused title of Sundt Unit 4 to be transferred to TEP.

**Refinancing Activity**

The TEP Credit Agreement, which consists of a \$150 million revolving credit facility and a \$341 million letter of credit facility, expires in August 2011. Interest rates and fees under the TEP Credit Agreement are based on a pricing grid tied to TEP's credit ratings. Letter of credit fees are 0.45% per annum and amounts drawn under a letter of credit would bear interest at LIBOR plus 0.45% per annum. Amounts drawn on the revolving credit facility bear interest at 0.45% per annum. For more information see *UniSource Energy Consolidated, Liquidity and Capital Resources, Liquidity*, above.

We are in the process of refinancing the TEP Credit Agreement and expect the transaction to be completed by the end of 2010. See *Liquidity and Capital Resources, Financing Activities, TEP Credit Agreement*, below for more information.

**Pension and Postretirement Benefit Expense**

In the third quarter and first nine months of 2010, TEP charged \$4 million and \$11 million, respectively, of pension and postretirement benefit costs to O&M expense. This compares with \$4 million and \$14 million in the same periods of 2009. For the full year 2010, TEP expects to charge \$14 million of pension and postretirement benefit costs to O&M expense, compared with \$17 million in 2009. The expected cost decrease in 2010 is due primarily to the increase in the market value of the pension assets. See *Financial Statements Note 8. Employee Benefit Plans*, for more information.

**El Paso Electric Dispute**

In 2006, El Paso filed a complaint with the FERC claiming that TEP must request service under El Paso's Open Access Transmission Tariff (OATT) in order to transmit power from Luna to TEP's system. TEP filed a counter complaint stating that TEP has existing rights under a 1982 Tucson-El Paso Transmission Agreement and, therefore, is not required to pay for transmission service under El Paso's OATT. In November 2008, the FERC issued an order supporting TEP's position.

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In December 2008, pending resolution, El Paso refunded to TEP \$10 million paid for transmission service from Luna to TEP's system during the period 2006 to 2008 and interest of \$1 million. TEP is not currently paying or accruing for transmission service under El Paso's OATT.

In July 2010, the FERC issued an order denying El Paso's request for rehearing of FERC's November 2008 order. In July, El Paso filed an appeal in the United States Court of Appeals for the District of Columbia Circuit. TEP intervened in the appeal proceeding. TEP has not recognized income as a result of the July 2010 FERC decision.

If El Paso were to prevail in its appeal, TEP would be required to pay for transmission service under El Paso's OATT from October 2008 through the date of the decision. For the period October 2008 to September 30, 2010, this additional transmission expense would approximate \$8 million. However, under the PPFAC mechanism, TEP would be allowed to recover \$7 million of this additional transmission expense from its retail customers.

In December 2008, TEP filed a complaint in the United States Federal District Court against El Paso seeking a \$2 million reimbursement from El Paso for transmission charges paid by TEP to Public Service Company of New Mexico (PNM) for transmission service in an attempt to mitigate TEP's damages before FERC issued its decision in November 2008. In September 2009, the District Court denied El Paso's motion to dismiss TEP's complaint and stayed the proceeding pending a final resolution of the FERC proceedings and any appeal.

TEP cannot predict the timing or outcome of this lawsuit.

**Renewable Energy Standard and Tariff**

In the first nine months of 2010, TEP collected \$24 million in Renewable Energy Standard and Tariff (RES) surcharges. Any surcharge collections above or below the amount of renewable expenditures are being deferred and reflected in TEP's financial statements as a regulatory liability or asset. TEP expects to collect \$32 million from customers through the 2010 RES surcharge. RES implementation plans and the associated surcharge must be submitted annually to the ACC for review and approval.

**2010 RES Implementation Plan**

In March 2010, the ACC approved TEP's 2010 RES implementation plan and found the proposed purchased power agreements and TEP-owned solar projects to be appropriate components. The plan includes two agreements to purchase 30 MW of capacity from two new Arizona-based solar systems which are expected to be completed in early 2012. The plan also includes a bio-mass project that is expected to provide TEP with 2 MW of capacity by 2012 or 2013. The above market costs associated with these contracts are recoverable through the RES surcharge. The solar purchased power agreements include an option allowing TEP to purchase the facilities in the future.

The approved plan also includes the expansion of TEP's Springerville photovoltaic installation by 1.8 MW and the construction of a new 1.6 MW solar project within the Tucson city limits. The estimated cost of these TEP-owned projects is approximately \$14 million. In May 2010, the ACC approved a funding mechanism for these two projects. The mechanism allows TEP to use RES funds to recover operating costs, depreciation, property taxes and provide TEP with a return on its investment in the two TEP-owned solar projects until these costs are recovered as part of TEP's base rates. We expect these projects to be completed by the end of 2010 and TEP to begin cost recovery through the RES in January 2011.

**2011 RES Implementation Plan**

In July 2010, TEP filed its 2011 RES implementation plan with the ACC. The target for 2011 is to supply 3% of TEP's annual retail sales from renewable energy resources. The plan includes agreements to purchase 100 MW of energy from solar resources and 50 MW of capacity from wind resources. In August 2010, the ACC found these additional purchased power agreements to be appropriate components of TEP's renewable energy portfolio.

The plan also includes a proposal to invest \$28 million per year in solar projects that would be owned by TEP. We estimate that each \$28 million investment would build approximately 7 MW of solar capacity. These TEP-owned solar projects would be installed between 2011 and 2014. The proposal includes the same funding mechanism that was approved by the ACC in May 2010. This funding mechanism would allow TEP to use RES funds to recover operating costs, depreciation, property taxes and a return on investment in the solar projects until these costs could be recovered as part of TEP's base rates.



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TEP estimates that it will need to collect \$49 million from retail customers to implement its proposed plan for 2011. TEP cannot predict when or if the ACC will approve its 2011 RES implementation plan.

**Electric Energy Efficiency Standards**

In August 2010, the ACC approved new Electric Energy Efficiency Standards (EE Standards) designed to require TEP, UNS Electric and other affected electric utilities to implement cost effective DSM programs. The EE Standards target total kWh savings in 2011 of 1.25% of 2010 sales. The EE Standards must be certified by the Arizona Attorney General before taking effect. We cannot predict if or when the Attorney General will certify the EE Standards. In 2009, TEP's programs saved 0.7% of 2009 sales. The EE Standards increase thereafter up to the targeted cumulative annual reduction in retail kWh sales of 22% by 2020. The EE Standards can be met by: new and existing DSM programs; direct load control programs; and by a portion of energy efficient building codes. The proposed EE Standards provide for the recovery of costs incurred to implement DSM programs. TEP's DSM programs and rates charged to customers for such programs are subject to ACC approval.

**Decoupling**

In October 2010, the Chairman of the ACC circulated for comment a draft policy statement regarding the need to adopt decoupling or another mechanism to make Arizona's proposed 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. We cannot predict if the ACC will allow TEP and other affected utilities to adopt the use of decoupling or other mechanisms.

**Rosemont Copper Mine**

In 2007, Augusta Resources Corporation (Augusta) filed a plan of operations with the United States Forest Service (USFS) for the proposed Rosemont Copper Mine near Tucson, Arizona. Augusta must receive a Record of Decision from the USFS prior to receiving permits for mine construction and operations. As part of the USFS decision process, it must issue an Environmental Impact Statement (EIS). A draft EIS is expected to be issued in late 2010 and public hearings are expected to occur in the first quarter of 2011. If the Rosemont Copper Mine reaches full production, it would become TEP's largest retail customer. TEP would serve approximately 100 MW of Rosemont Copper Mine's total estimated load of approximately 110 MW. TEP cannot predict if or when the mine will commence operations.

**Fair Value Measurements**

The following table sets forth, by level within the fair value hierarchy, TEP's financial assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2010. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

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|  | <b>TEP</b>  |  |  |              |             |
|--|---|--|--|--------------|-------------|
|  | <b>Quoted Prices<br/>in<br/>Active<br/>Markets for<br/>Identical<br/>Assets<br/>(Level 1)</b> | <b>Significant<br/>Other<br/>Observable<br/>Inputs<br/>(Level 2)</b> | <b>Significant<br/>Unobservable<br/>Inputs<br/>(Level 3)</b> | <b>Total</b> |             |
|  | <b>September 30, 2010</b>   |  |  |              |             |
|  | <b>- Millions of Dollars -</b>  |  |  |              |             |
| <b>Assets</b>  |   |  |  |              |             |
| Cash Equivalents <sup>(1)</sup>  | \$ 10   | \$   | \$   | \$           | \$ 10       |
| Rabbi Trust Investments to support the<br>Deferred Compensation and SERP Plans<br><sup>(2)</sup> |   |  | 15   |              | 15          |
| Energy Contracts <sup>(3)</sup>  |   |  |  | 5            | 5           |
| <b>Total Assets</b>  | <b>10</b>   |  | <b>15</b>  | <b>5</b>     | <b>30</b>   |
| <b>Liabilities</b>   |   |  |  |              |             |
| Energy Contracts <sup>(3)</sup>  |   |  | (8)  | (3)          | (11)        |
| Interest Rate Swaps <sup>(4)</sup>   |   |  | (13)   |              | (13)        |
| <b>Total Liabilities</b>   |   |  | <b>(21)</b>  | <b>(3)</b>   | <b>(24)</b> |
| <b>Net Total Assets and (Liabilities)</b>  | <b>\$ 10</b>  | <b>\$</b>  | <b>(6)</b>   | <b>\$ 2</b>  | <b>\$ 6</b> |

(1) Cash Equivalents are based on observable market prices and are comprised of the fair value of money market funds and commercial paper.

(2) Rabbi Trust Investments consist of amounts held in mutual and money market funds related to deferred compensation and Supplemental Executive Retirement Plan



(SERP) benefits.  
The valuation is based on quoted prices, traded in active markets. These investments are included in Investments and Other Property Other in the UniSource Energy and TEP balance sheets.

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

(4) The Interest Rate Swaps are valued based on the six month LIBOR index or the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index. These interest rate swaps are included in Derivative Instruments in the

UniSource Energy  
and TEP balance  
sheets.

For the nine months ended September 30, 2010, TEP recorded net unrealized gains of \$4 million in net regulatory assets. This amount represents \$8 million in unrealized gains related to the change in the fair value of Level 3 forward power contracts primarily due to the change in value of the purchase power call option, partially offset by \$4 million in unrealized losses related to the change in fair value of Level 2 gas swaps due to lower forward gas prices and increased swap volumes.

TEP primarily applies the market approach for recurring fair value measurements and endeavors to utilize the best available information. Where observable inputs are available for substantially the full term of the asset or liability, such as gas swap derivatives valued using New York Mercantile Exchange (NYMEX) pricing, adjusted for basis differentials, the instrument is categorized in Level 2.

Derivatives valued using an aggregate pricing service or published prices that represent a consensus reporting of multiple brokers are categorized in Level 3. For both power and gas prices, TEP obtains quotes from brokers, major market participants, exchanges or industry publications as well as its own price experience from active transactions in the market. TEP primarily uses one set of quotations each for power and for gas, and then uses the other sources as validation of those prices. The broker providing quotes for power prices states that the market information provided is indicative only, but believes it to be reflective of market conditions as of the time and date indicated. In addition, energy derivatives include contracts where published prices are not readily available. These include contracts for delivery periods during non-standard time blocks, contracts for delivery during only a few months of a given year when prices are quoted only for the annual average, or contracts for delivery at illiquid delivery points. In these cases, TEP applies certain management assumptions to value such contracts. These assumptions include applying percentage multipliers to value non-standard time blocks, applying historical price curve relationships to calendar year quotes, and including adjustments for transmission and line losses to value contracts at illiquid delivery points. We also consider the impact of counterparty credit risk using current and historical default and recovery rates as well as our own credit risk using market credit default swap data. TEP reviews these assumptions on a quarterly basis.

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

**LIQUIDITY AND CAPITAL RESOURCES****TEP Cash Flows**

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

| <b>Nine Months Ended September 30,</b>  | <b>2010</b>           | <b>2009</b> |
|---|-----------------------|-------------|
|   | -Millions of Dollars- |             |
| Net Cash Flows Operating Activities (GAAP)  | \$ 214                | \$ 197      |
| Amounts from Statements of Cash Flows:  |                       |             |
| Less: Capital Expenditures (1)  | (218)                 | (195)       |
| Net Cash Flows after Capital Expenditures (non-GAAP)*   | (4)                   | 2           |
| Amounts from Statements of Cash Flows:  |                       |             |
| Less: Retirement of Capital Lease Obligations   | (56)                  | (24)        |
| Plus: Proceeds from Investment in Lease Debt  | 26                    | 13          |
| Net Cash Flows after Capital Expenditures and Required Payments on Debt and Capital Lease Obligations (non-GAAP)* | \$ (34)               | \$ (9)      |

(1) Includes \$52 million payment for purchase of Sundt Unit 4 lease equity.

| <b>Nine Months Ended September 30,</b>  | <b>2010</b>           | <b>2009</b> |
|---|-----------------------|-------------|
|   | -Millions of Dollars- |             |
| Net Cash Flows Operating Activities (GAAP)  | \$ 214                | \$ 197      |
| Net Cash Flows Investing Activities (GAAP)  | (191)                 | (209)       |
| Net Cash Flows Financing Activities (GAAP)  | (22)                  | (8)         |
| Net Cash Flows after Capital Expenditures (non-GAAP)*   | (4)                   | 2           |
| Net Cash Flows after Capital Expenditures and Required Payments on Debt and Capital Lease Obligations (non-GAAP)* | (34)                  | (9)         |

\* Net Cash Flows after Capital Expenditures and Net Cash Flows Available after Required Payments, both non-GAAP

measures of liquidity, should not be considered as alternatives to Net Cash Flows - Operating Activities, which is determined in accordance with GAAP as a measure of liquidity. TEP believes that Net Cash Flows after Capital Expenditures and Net Cash Flows Available after Required Payments provide useful information to investors as measures of liquidity and its ability to fund its capital requirements, make required payments on debt and capital lease obligations, and pay dividends to UniSource Energy.

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**Liquidity Outlook**

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

**Operating Activities**

In the first nine months of 2010, net cash flows from operating activities increased by \$17 million compared with 2009. Net cash flows were impacted by:

- a \$26 million increase in cash receipts from retail and wholesale electric sales, net of fuel and purchased power costs, due in part to a decline in gas prices;
- a \$16 million increase in cash receipts related to the operation of Springerville Units 3 and 4;
- an \$8 million decrease in cash deposits made with power and gas trading counterparties, net of cash deposits received; partially offset by
- a \$7 million decrease in income tax refunds; and
- a \$13 million increase in total taxes paid.

**Investing Activities**

Net cash flows used for investing activities decreased by \$18 million in the first nine months of 2010 compared with the same period last year due to: a \$13 million increase in proceeds from the return of investments in lease debt; a \$4 million decrease in insurance proceeds; and the use of \$31 million in the first nine months of 2009 for an investment in lease debt; partially offset by a \$23 million increase in capital expenditures, which includes the purchase of Sundt Unit 4.

**Financing Activities**

Net cash used for financing activities was \$14 million higher in the first nine months of 2010 compared with 2009 due to: a \$32 million increase in TEP's payments on capital lease obligations; and a \$15 million decrease in equity investments from UniSource Energy. These factors were partially offset by \$30 million of proceeds received under a loan agreement to help fund the purchase of Sundt Unit 4 and a \$5 million increase in borrowings, net of repayments, under TEP's revolving credit facility.

**TEP Term Loan**

In March 2010, TEP entered into a \$30 million term loan agreement (TEP Term Loan) that was due to expire on September 1, 2011. The proceeds were used to help fund a portion of the purchase of Sundt Unit 4 and for other general corporate purposes. The TEP Term Loan was secured by \$30 million of mortgage bonds issued under TEP's 1992 Mortgage. TEP repaid the term loan in October 2010.

**TEP Credit Agreement**

The TEP Credit Agreement consists of a \$150 million revolving credit facility and a \$341 million letter of credit facility which supports \$329 million of tax-exempt variable rate bonds. The TEP Credit Agreement expires in August 2011 and is secured by \$491 million of Mortgage Bonds. We are in the process of refinancing the TEP Credit Agreement. See *TEP, Factors Affecting Results of Operations, Refinancing Activity* for more information. As of September 30, 2010, TEP was in compliance with the terms of the TEP Credit Agreement and had \$55 million of outstanding borrowings and \$1 million in letters of credit outstanding under the TEP Revolving Credit Facility. As of October 15, 2010, there were no outstanding borrowings and less than \$1 million in letters of credit outstanding under TEP's Revolving Credit Facility.

**Table of Contents****Capital Contribution from UniSource Energy**

In March 2010, UniSource Energy contributed \$15 million of capital to TEP to help fund the purchase of Sundt Unit 4. In March 2009, UniSource Energy contributed \$30 million of capital to TEP which it used to purchase Springerville Unit 1 lease debt.

**Bond Issuances**

In October 2010, the Pima Authority issued \$100 million of its 2010 Series A tax-exempt Industrial Development Revenue Bonds (IDBs) for TEP's benefit. The 2010 Pima Series A IDBs are unsecured, bear interest at a rate of 5.25%, mature in October 2040, and are callable at par on or after October 1, 2020. Net of an underwriting discount, \$99 million of proceeds were deposited in a construction fund with the bond trustee. The proceeds are to be applied to the construction of certain of TEP's transmission and distribution facilities used to provide electric service in Pima County. TEP drew down \$74 million of the proceeds from the construction fund at closing, with the remaining \$25 million expected to be drawn down by the end of the first quarter of 2011.

**Interest Rate Risk**

TEP is exposed to interest rate risk resulting from changes in interest rates on certain of its variable rate debt obligations, as well as borrowings under its revolving credit facility. As a result, TEP may be required to pay significantly higher rates of interest on outstanding variable rate debt and borrowings under its revolving credit facility. At September 30, 2010 and December 31, 2009, TEP had \$329 million and \$459 million, respectively, in tax-exempt variable rate debt outstanding.

The interest rates on TEP's tax-exempt variable rate debt are reset weekly by its remarketing agents. The maximum interest payable under the indenture for the bonds is 20%. During 2010, the average interest rates paid ranged from 0.17% to 0.33%. At September 30, 2010, the average interest rate on the debt was 0.26%.

**Capital Lease Obligations**

At September 30, 2010, TEP had \$487 million of total capital lease obligations on its balance sheet. The table below provides a summary of the outstanding lease amounts in each of the obligations.

| <b>Leased Asset</b>                    | <b>Capital Lease<br/>Obligation<br/>Balance<br/>at September 30,<br/>2010</b> | <b>Expiration</b> | <b>Renewal/Purchase<br/>Option</b>                  |
|--|---|-------------------|---|
|  | -Millions of Dollars -  |                   |   |
| Springerville Unit 1                   | \$ 302  | 2015              | Fair market value<br>purchase option                |
| Springerville Coal Handling Facilities | 77  | 2015              | Fixed price purchase<br>option of \$120 million (1) |
| Springerville Common Facilities        | 108   | 2017 and 2021     | Fixed price purchase<br>option of \$106 million (1) |
| Total Capital Lease Obligations        | \$ 487  |                   |   |

(1) TEP has agreed with Tri-State and SRP, the owners of Springerville Units 3 and 4,

respectively,  
that if these  
leases are not  
renewed, it will  
exercise such  
purchase  
options.

Tri-State and  
SRP will then  
be obligated to  
either (i) buy a  
portion of these  
facilities or  
(ii) continue  
making  
payments to  
TEP for the  
usage of these  
facilities.

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

**Table of Contents****Income Tax Position**

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

**Contractual Obligations**

There have been no significant changes in TEP's contractual obligations or other commercial commitments from those reported in our 2009 Annual Report on Form 10-K, other than the following purchase obligations entered into in 2010 and the TEP Term Loan:

| Payment Due in Years<br>Ending December 31,      | 2010  | 2011  | 2012 | 2013 | 2014 | 2015<br>and<br>after | Total |
|--|-------|-------|------|------|------|----------------------|-------|
| - Millions of Dollars -                          |       |       |      |      |      |                      |       |
| Long-Term Debt <sup>(1)</sup>                    | \$ 30 | \$    | \$   | \$   | \$   | \$                   | \$ 30 |
| Purchase Obligations:                            |       |       |      |      |      |                      |       |
| Purchased Power                                  |       | 15    |      |      |      |                      | 15    |
| Solar Installation Commitments                   | 4     | 2     |      |      |      |                      | 6     |
| Total Additional Contractual Cash<br>Obligations | \$ 34 | \$ 17 | \$   | \$   | \$   | \$                   | \$ 51 |

(1) The TEP term loan was repaid in October 2010.

**Dividends on Common Stock**

TEP can pay dividends if it maintains compliance with the TEP Credit Agreement and TEP Term Loan and certain financial covenants. As of September 30, 2010, TEP was in compliance with the terms of the TEP Credit Agreement, the TEP Term Loan and applicable financial covenants.

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

In August 2010, TEP paid a \$30 million dividend to UniSource Energy.

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

UNS Gas reported a net loss of \$1 million in the third quarters of 2010 and 2009, respectively. For the nine month periods ending on September 30, UNS Gas reported net income in 2010 and 2009 of \$5 million and \$4 million, respectively. The improvement in UNS Gas net income in the first nine months of 2010 is primarily due to cooler weather that led to an increase in retail therm sales and a base rate increase that was effective in April 2010.



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The table below provides summary financial information for UNS Gas.

|  | <b>Three Months Ended<br/>September 30,</b> |               | <b>Nine Months Ended<br/>September 30,</b> |             |
|--|---|---------------|--|-------------|
|  | <b>2010</b>                                 | <b>2009</b>   | <b>2010</b>                                | <b>2009</b> |
|  | <b>- Millions of Dollars -</b>              |               | <b>- Millions of Dollars -</b>             |             |
| Gas Revenues                             | \$ 19                                       | \$ 18         | \$ 101                                     | \$ 103      |
| Other Revenues                           |   | 1             | 2  | 3           |
| <b>Total Operating Revenues</b>          | <b>19</b>                                   | <b>19</b>     | <b>103</b>                                 | <b>106</b>  |
| Purchased Gas Expense                    | 10  | 11            | 62   | 69          |
| Other Operations and Maintenance Expense | 6   | 6             | 19   | 19          |
| Depreciation and Amortization            | 2   | 2             | 6  | 5           |
| Taxes Other Than Income Taxes            | 1   | 1             | 2  | 2           |
| <b>Total Operating Expenses</b>          | <b>19</b>                                   | <b>20</b>     | <b>89</b>                                  | <b>95</b>   |
| <b>Operating Income (Loss)</b>           |   | <b>(1)</b>    | <b>14</b>                                  | <b>11</b>   |
| Total Interest Expense                   | 2   | 1             | 5  | 5           |
| Income Tax Expense (Benefit)             | (1)   | (1)           | 4  | 2           |
| <b>Net Income (Loss)</b>                 | <b>\$ (1)</b>                               | <b>\$ (1)</b> | <b>\$ 5</b>                                | <b>\$ 4</b> |

The tables below include UNS Gas therm sales and revenues for the three and nine months ending September 30, 2010 and 2009.

| <b>Three Months Ended September 30,<br/>Energy Sales, Therms (in millions)</b> | <b>2010</b> | <b>2009</b> | <b>Increase (Decrease)</b> |                 |
|--|-------------|-------------|----------------------------|-----------------|
|  |             |             | <b>Amount</b>              | <b>Percent*</b> |
| <b>Gas Retail Sales:</b>   |             |             |                            |                 |
| Residential  | 5           | 5           |                            | (1.8%)          |
| Commercial   | 4           | 4           |                            | 0.7%            |
| Industrial   |             |             |                            | (11.3%)         |
| Public Authorities   | 1           | 1           |                            | (1.2%)          |
| <b>Total Gas Retail Sales</b>  | <b>10</b>   | <b>10</b>   |                            | <b>(1.1%)</b>   |
| Negotiated Sales Program (NSP)   | 9           | 8           | 1                          | 9.6%            |
| <b>Total Gas Sales</b>   | <b>19</b>   | <b>18</b>   | <b>1</b>                   | <b>3.9%</b>     |
| <b>Gas Revenues (in millions):</b>   |             |             |                            |                 |
| <b>Retail Margin Revenues:</b>   |             |             |                            |                 |
| Residential  | \$ 6        | \$ 5        | \$ 1                       | 10.4%           |
| Commercial   | 2           | 2           |                            | 9.0%            |
| Industrial   |             |             |                            | 5.0%            |
| Public Authorities   |             |             |                            | 5.2%            |

|                                     |    |    |    |    |    |     |         |
|-------------------------------------|----|----|----|----|----|-----|---------|
| <b>Total Retail Margin Revenues</b> | \$ | 8  | \$ | 7  | \$ | 1   | 10.0%   |
| Transport                           |    | 1  |    | 1  |    |     | 3.4%    |
| Negotiated Sales Program (NSP)      |    | 4  |    | 3  |    | 1   | 38.5%   |
| Retail Fuel Revenues                |    | 6  |    | 7  |    | (1) | (16.9%) |
| <b>Total Gas Revenues</b>           | \$ | 19 | \$ | 18 | \$ | 1   | 3.8%    |

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

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Retail therm sales decreased 1.1% in the third quarter of 2010 compared with the same period last year. Through a Negotiated Sales Program (NSP) approved by the ACC, customers who receive gas transmission services from UNS Gas may also elect to purchase gas from UNS Gas. Approximately one half of the margin earned on these NSP sales is retained by UNS Gas, while the remainder benefits retail customers through a credit to the PGA mechanism which reduces the gas commodity price.

| <b>Nine Months Ended September 30,<br/>Energy Sales, Therms (in millions)</b> | <b>2010</b>   | <b>2009</b>   | <b>Amount</b> | <b>Percent*</b> |
|---|---------------|---------------|---------------|-----------------|
| <b>Gas Retail Sales:</b>  |               |               |               |                 |
| Residential   | 50            | 45            | 5             | 11.4%           |
| Commercial  | 21            | 19            | 2             | 6.8%            |
| Industrial  | 1             | 2             | (1)           | (6.2%)          |
| Public Authorities  | 4             | 4             |               | 10.1%           |
| <b>Total Gas Retail Sales</b>   | <b>76</b>     | <b>70</b>     | <b>6</b>      | <b>9.7%</b>     |
| Negotiated Sales Program (NSP)  | 22            | 24            | (2)           | (11.0%)         |
| <b>Total Gas Sales</b>  | <b>98</b>     | <b>94</b>     | <b>4</b>      | <b>4.4%</b>     |
| <b>Gas Revenues (in millions):</b>  |               |               |               |                 |
| <b>Retail Margin Revenues:</b>  |               |               |               |                 |
| Residential   | \$ 28         | \$ 25         | \$ 3          | 11.3%           |
| Commercial  | 7             | 6             | 1             | 9.8%            |
| Industrial  |               |               |               | 1.6%            |
| Public Authorities  | 1             | 1             |               | 11.1%           |
| <b>Total Retail Margin Revenues</b>   | <b>\$ 36</b>  | <b>\$ 32</b>  | <b>\$ 4</b>   | <b>11.0%</b>    |
| Transport   | 3             | 3             |               | 0.7%            |
| Negotiated Sales Program (NSP)  | 11            | 10            | 1             | 8.3%            |
| Retail Fuel Revenues  | 51            | 58            | (7)           | (12.1%)         |
| <b>Total Gas Revenues</b>   | <b>\$ 101</b> | <b>\$ 103</b> | <b>\$ (2)</b> | <b>(2.3%)</b>   |

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

Retail therm sales increased by 9.7% in the first nine months of 2010 due primarily to colder winter weather compared with last year. The base rate increase that was implemented on April 1, 2010 and the increase in therm sales volumes contributed to an increase in retail margin revenues of \$4 million compared with the first nine months of 2009.

**FACTORS AFFECTING RESULTS OF OPERATIONS****Rates**2010 UNS Gas Rate Order

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In November 2008, UNS Gas filed a general rate case with the ACC on a cost of service basis requesting a \$10 million, or a 6% base rate increase. In March 2010, the ACC issued an order authorizing a 2%, or \$3 million base rate increase effective April 2010.

| Test year 12 months ended June 30, 2008       | Requested by UNS Gas  | 2010 ACC Order        |
|---|-----------------------|-----------------------|
| Original cost rate base                       | \$182 million         | \$180 million         |
| Revenue deficiency                            | \$10 million          | \$3 million           |
| Total rate increase (over test year revenues) | 6%                    | 2%                    |
| Cost of equity                                | 11.0%                 | 9.5%                  |
| Actual capital structure                      | 50% equity / 50% debt | 50% equity / 50% debt |
| Weighted average cost of capital              | 8.75%                 | 8.0%                  |



certificates of  
deposit and  
commercial paper.

- (2) Cash collateral provided to energy contract counterparties to reduce credit risk exposure. Collateral posted is included in Current Assets - Other in the UniSource Energy balance sheet.
- (3) Energy Contracts include gas swap agreements entered into to reduce exposure to energy price risk. They are valued using New York Mercantile Exchange (NYMEX) pricing, adjusted for basis differences. The amounts include current and non-current liabilities and are net of current and non-current assets, and are included in Derivative Instruments in the UniSource Energy balance sheet.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Liquidity Outlook**

In the first nine months of 2010, capital expenditures were \$7 million. UNS Gas expects operating cash flows to fund its future operating activities and a large portion of its construction expenditures. If natural gas prices rise and UNS Gas is not allowed to recover its projected gas costs or PGA bank balance on a timely basis, UNS Gas may require additional funding to meet operating and capital requirements. Sources of funding future capital expenditures could include draws on the revolving credit facility, additional credit lines, the issuance of long-term debt, or capital contributions from UniSource Energy.

**Table of Contents****Operating Cash Flows**

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

| <b>Nine Months Ended September 30,</b> | <b>2010</b>           | <b>2009</b> |
|--|-----------------------|-------------|
|  | -Millions of Dollars- |             |
| Cash provided by (used in):            |                       |             |
| Operating Activities                   | \$ 10                 | \$ 28       |
| Investing Activities                   | (6)                   | (11)        |
| Financing Activities                   | (10)                  | 1           |
| Net Increase (Decrease) in Cash        | (6)                   | 18          |
| Beginning Cash                         | 31                    | 7           |
| Ending Cash                            | \$ 25                 | \$ 25       |

Operating cash flows decreased in the first nine months of 2010 due primarily to the return of over-collected gas costs to customers.

**UNS Gas/UNS Electric Revolver**

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

The UNS Gas/UNS Electric Revolver contains restrictions on additional indebtedness, liens, mergers and sales of assets; it also contains a maximum leverage ratio and a minimum cash flow to interest coverage ratio for each borrower. UNS Gas expects to draw upon the UNS Gas/UNS Electric Revolver from time to time for seasonal working capital purposes, to fund a portion of its capital expenditures or to issue letters of credit to provide credit enhancement for its energy procurement and hedging activities. As of September 30, 2010, UNS Gas and UNS Electric were each in compliance with the terms of the UNS Gas/UNS Electric Revolver. As of September 30, 2010, UNS Gas had no outstanding borrowings and no outstanding letters of credit under the UNS Gas/UNS Electric Revolver.

We are in the process of refinancing the UNS Gas/UNS Electric Revolver and expect the transaction to be completed by the end of 2010. For more information see *UniSource Energy Consolidated, Liquidity and Capital Resources, Liquidity*, above.

**Interest Rate Risk**

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

**Senior Unsecured Notes**

UNS Gas has \$100 million of senior unsecured notes outstanding consisting of \$50 million at 6.23% due in 2011 and \$50 million at 6.23% due in 2015, each of which are guaranteed by UES. The note purchase agreement for UNS Gas restricts transactions with affiliates, mergers, liens, restricted payments and incurrence of indebtedness, and also contains a minimum net worth test. As of September 30, 2010, UNS Gas was in compliance with the terms of its note purchase agreement.

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

There have been no significant changes in UNS Gas contractual obligations or other commercial commitments from those reported in our 2009 Annual Report on Form 10-K, other than the following purchase obligations entered into in 2010:

| Payment Due in Years<br>Ending December 31, | 2010 | 2011 | 2012 | 2013 | 2014 | 2015<br>and<br>after | Total |
|---|------|------|------|------|------|----------------------|-------|
| - Millions of Dollars -                     |      |      |      |      |      |                      |       |
| Purchase Obligations:                       |      |      |      |      |      |                      |       |
| Fuel  | \$   | \$ 4 | \$ 4 | \$ 2 | \$   | \$                   | \$ 10 |

**Dividends on Common Stock**

In April 2010, UNS Gas paid a dividend of \$10 million to UniSource Energy. UNS Gas ability to pay future dividends will depend on the cash needs for capital expenditures and various other factors.

The note purchase agreement for UNS Gas contains restrictions on dividends. UNS Gas may pay dividends so long as (a) no default or event of default exists and (b) it could incur additional debt under the debt incurrence test. As of September 30, 2010, UNS Gas was in compliance with the terms in its note purchase agreement. See *Senior Unsecured Notes*, above.

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

UNS Electric reported net income of \$3 million in the third quarter of 2010 compared to \$4 million in the third quarter of 2009. For the nine months ended September 30, 2010, UNS Electric reported net income of \$8 million compared with net income of \$6 million in the same period last year. Results in the first nine months of 2010 include \$2 million of after-tax income related to a settlement with APS for refunds related to transactions with the California Power Exchange.

Similar to TEP, UNS Electric's operations are generally seasonal in nature, with peak energy demand occurring in the summer months.

The table below provides summary financial information for UNS Electric.

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|  | <b>2010</b>               | <b>2009</b> | <b>2010</b>              | <b>2009</b> |
| - Millions of Dollars -                  |                           |             |                          |             |
| Retail Electric Revenues                 | \$ 59                     | \$ 51       | \$ 139                   | \$ 142      |
| Wholesale Electric Revenues              | 13                        | 1           | 22                       | 4           |
| Other Revenues                           | 1                         | 1           | 1                        | 1           |
| <b>Total Operating Revenues</b>          | <b>73</b>                 | <b>53</b>   | <b>162</b>               | <b>147</b>  |
| Total Fuel and Purchased Energy Expense  | 53                        | 35          | 111                      | 102         |
| Other Operations and Maintenance Expense | 8                         | 6           | 22                       | 17          |
| Depreciation and Amortization            | 4                         | 4           | 11                       | 11          |
| Taxes Other Than Income Taxes            | 1                         | 1           | 3                        | 3           |
| <b>Total Operating Expenses</b>          | <b>66</b>                 | <b>46</b>   | <b>147</b>               | <b>133</b>  |
| <b>Operating Income</b>                  | <b>7</b>                  | <b>7</b>    | <b>15</b>                | <b>14</b>   |



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|                        |   |    |   |    |   |    |   |    |   |
|------------------------|---|----|---|----|---|----|---|----|---|
| Other Income           |   |    |   |    | 3 |    |   |    |   |
| Total Interest Expense | 2 |    | 1 |    | 5 |    |   | 5  |   |
| Income Tax Expense     | 2 |    | 2 |    | 5 |    |   | 3  |   |
| <b>Net Income</b>      |   | \$ | 3 | \$ | 4 | \$ | 8 | \$ | 6 |

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The table below shows UNS Electric's kWh sales and revenues for the third quarters of 2010 and 2009.

| Three Months Ended September 30,<br>Energy Sales, kWh (in millions) | 2010         | 2009         | Increase (Decrease) |              |
|---|--------------|--------------|---------------------|--------------|
|   |              |              | Amount              | Percent*     |
| <b>Electric Retail Sales:</b>                                       |              |              |                     |              |
| Residential   | 301          | 301          |                     | (0.1%)       |
| Commercial  | 181          | 185          | (4)                 | (2.2%)       |
| Industrial  | 62           | 56           | 6                   | 10.0%        |
| Mining  | 51           | 43           | 8                   | 18.8%        |
| Public Authorities  | 1            | 1            |                     | (3.7%)       |
| <b>Total Electric Retail Sales</b>                                  | <b>596</b>   | <b>586</b>   | <b>10</b>           | <b>1.7%</b>  |
| <b>Electric Wholesale Sales</b>                                     | <b>257</b>   | <b>31</b>    | <b>226</b>          | <b>NM</b>    |
| <b>Total Electric Sales</b>   | <b>853</b>   | <b>617</b>   | <b>236</b>          | <b>38.1%</b> |
| <b>Electric Retail Revenues (in millions):</b>                      |              |              |                     |              |
| <b>Retail Margin Revenues:</b>                                      |              |              |                     |              |
| Residential   | \$ 7         | \$ 7         | \$                  | 1.0%         |
| Commercial  | 6            | 6            |                     | (2.5%)       |
| Industrial  | 2            | 2            |                     | 9.4%         |
| Mining  | 1            | 1            |                     | 33.7%        |
| Public Authorities  |              |              |                     | (4.7%)       |
| <b>Total Retail Margin Revenues</b>                                 | <b>\$ 16</b> | <b>\$ 16</b> | <b>\$</b>           | <b>2.2%</b>  |
| Retail Fuel Revenues  | 40           | 34           | 6                   | 17.0%        |
| DSM and RES Revenues  | 3            | 1            | 2                   | NM           |
| <b>Total Retail Revenues</b>  | <b>59</b>    | <b>51</b>    | <b>8</b>            | <b>15.8%</b> |
| Electric Wholesale Revenues   | 13           | 1            | 12                  | NM           |
| <b>Total Electric Revenues</b>                                      | <b>\$ 72</b> | <b>\$ 52</b> | <b>\$ 20</b>        | <b>37.2%</b> |

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

Total retail kWh sales in the third quarter of 2010 increased by 1.7% compared with the same period last year. Energy sales to residential and commercial customers decreased in the third quarter of 2010 due to regional economic conditions and fewer cooling degree days compared with the same period last year. UNS Electric's mining kWh sales increased by 18.8% as its largest mining customer continues to increase its production. UNS Electric's retail customer count changed by a minimal amount compared with September 30, 2009.



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The table below shows UNS Electric's kWh sales and revenues for the first nine months of 2010 and 2009.

| Nine Months Ended September 30,<br>Energy Sales, kWh (in millions) | 2010          | 2009          | Increase (Decrease) |               |
|--|---------------|---------------|---------------------|---------------|
|  |               |               | Amount              | Percent*      |
| <b>Electric Retail Sales:</b>                                      |               |               |                     |               |
| Residential  | 652           | 652           |                     | 0.1%          |
| Commercial   | 470           | 479           | (9)                 | (1.9%)        |
| Industrial   | 166           | 144           | 22                  | 14.7%         |
| Mining   | 149           | 116           | 33                  | 28.0%         |
| Public Authorities   | 2             | 2             |                     | (4.2%)        |
| <b>Total Electric Retail Sales</b>                                 | <b>1,439</b>  | <b>1,393</b>  | <b>46</b>           | <b>3.3%</b>   |
| <b>Electric Wholesale Sales</b>                                    | <b>475</b>    | <b>105</b>    | <b>370</b>          | <b>NM</b>     |
| <b>Total Electric Sales</b>  | <b>1,914</b>  | <b>1,498</b>  | <b>416</b>          | <b>27.8%</b>  |
| <b>Electric Retail Revenues (in millions):</b>                     |               |               |                     |               |
| <b>Retail Margin Revenues:</b>                                     |               |               |                     |               |
| Residential  | \$ 16         | \$ 16         | \$                  | 0.9%          |
| Commercial   | 17            | 17            |                     | (1.0%)        |
| Industrial   | 6             | 5             | 1                   | 16.3%         |
| Mining   | 3             | 2             | 1                   | 29.2%         |
| Public Authorities   |               |               |                     | (1.4%)        |
| <b>Total Retail Margin Revenues</b>                                | <b>\$ 42</b>  | <b>\$ 40</b>  | <b>\$ 2</b>         | <b>3.6%</b>   |
| Retail Fuel Revenues   | 90            | 99            | (9)                 | (8.4%)        |
| DSM and RES Revenues   | 7             | 3             | 4                   | NM            |
| <b>Total Retail Revenues</b>                                       | <b>139</b>    | <b>142</b>    | <b>(3)</b>          | <b>(2.0%)</b> |
| Electric Wholesale Revenues  | 22            | 4             | 18                  | NM            |
| <b>Total Electric Revenues</b>                                     | <b>\$ 161</b> | <b>\$ 146</b> | <b>\$ 15</b>        | <b>10.5%</b>  |

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

Total retail kWh sales in the first nine months of 2010 increased by 3.3% compared with the same period last year, which led to a \$2 million increase in retail margin revenues. The increase can be attributed to an increase in production by UNS Electric's mining customer as well as the addition of a new industrial customer. Energy sales to commercial customers decreased in the first nine months of 2010 due to regional economic conditions and fewer cooling degree days compared with the same period last year.

**FACTORS AFFECTING RESULTS OF OPERATIONS**

**Rates**2010 UNS Electric Rate Order

On April 30, 2009, UNS Electric filed a rate case application with the ACC on a cost of service basis. In September 2010, the ACC issued an order authorizing a 4%, or \$7.4 million base rate increase effective October 1, 2010.

| Test year December 31, 2008                   | Requested by<br>UNS Electric | 2010 ACC Order        |
|---|------------------------------|-----------------------|
| Original cost rate base                       | \$176 million                | \$169 million         |
| Revenue deficiency                            | \$13.5 million               | \$7.4 million         |
| Total rate increase (over test year revenues) | 7.4%                         | 4%                    |
| Cost of debt                                  | 7.05%                        | 7.05%                 |
| Cost of equity                                | 11.40%                       | 9.75%                 |
| Actual capital structure                      | 46% equity / 54% debt        | 46% equity / 54% debt |
| Weighted average cost of capital              | 9.04%                        | 8.28%                 |

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The ACC also approved the acquisition and inclusion of BMGS in UNS Electric's rate base, subject to various conditions including: an operational review of BMGS by ACC Staff; a filing by UNS Electric to show that the acquisition and inclusion of BMGS in rate base will not impact the amount of the total revenue increase authorized by the ACC; and FERC approval. Upon its purchase, BMGS will be included in UNS Electric's rate base through a revenue-neutral rate reclassification of approximately 0.7 cents per kWh from base power supply rate to non-fuel base rates. UNS Electric currently purchases all the output of BMGS under a contract with UED.

UNS Electric expects to file an application with FERC by the end of 2010 to get approval to purchase BMGS. If UNS Electric receives FERC approval and meets the other conditions set forth in the September 2010 Rate Order, we expect the acquisition of BMGS to be completed and included in UNS Electric's rate base during 2011.

The 2010 Rate Order also approved a plan for UNS Electric to invest \$5 million each year from 2011 through 2014 in solar projects that would be owned by UNS Electric. We estimate that each \$5 million investment would build approximately 1.25 MW of solar capacity. The ACC also approved a funding mechanism that will allow UNS Electric to use RES funds to recover operating costs, depreciation, property taxes and provide UNS Electric with a return on its investment in the UNS Electric-owned solar projects until these costs could be recovered as part of UNS Electric's base rates. We expect the first project to be completed by the end of 2011 and UNS Electric to begin cost recovery through the RES in January 2012.

**Purchased Power and Fuel Adjustment Clause**

UNS Electric's PPFAC mechanism has a forward component and a true-up component. The forward component of the PPFAC rate is based on forecasted fuel and purchased power costs. The cap on the PPFAC forward component, over the 6.77 cents per kWh in base rates, is 1.845 cents per kWh. The true-up component reconciles actual fuel and purchased power costs with the amounts collected in the prior year and any amounts under/over-collected will be collected/credited from/to customers.

**Renewable Energy Standard**

In the first nine months of 2010, UNS Electric collected \$6 million in RES surcharges. Any surcharge collections above or below the amount of renewable expenditures are being deferred and reflected in UNS Electric's financial statements as a regulatory liability or asset. UNS Electric expects to collect \$8 million from customers through the 2010 RES surcharge. RES implementation plans and the associated surcharge must be submitted annually to the ACC for review and approval.

In July 2010, UNS Electric filed its 2011 RES implementation plan with the ACC. The target for 2011 is to supply 3% of UNS Electric's annual retail sales from renewable energy resources. UNS Electric estimates that it will need to collect \$12 million from retail customers during 2011 to implement its proposed plan. UNS Electric cannot predict when or if the ACC will approve its 2011 RES implementation plan.

**Electric Energy Efficiency Standards**

In August 2010, the ACC approved new EE Standards designed to require UNS Electric, TEP and other affected utilities to implement cost effective DSM programs. The EE Standards target total kWh savings in 2011 of 1.25% of 2010 sales. The EE Standards must be certified by the Arizona Attorney General before taking effect. We cannot predict if or when the Attorney General will certify the EE Standards.

In 2009, UNS Electric's programs saved 0.5% of 2009 sales. The EE Standards increase thereafter up to the targeted cumulative annual reduction in retail kWh sales of 22% by 2020. The EE Standards can be met by: new and existing DSM programs; direct load control programs; and from a portion of energy efficient building codes. The proposed EE Standards provide for the recovery of costs incurred to implement DSM programs. UNS Electric's DSM programs and rates charged to customers for such programs are subject to ACC approval.

**Decoupling**

In October 2010, the Chairman of the ACC circulated for comment a draft policy statement regarding the need to adopt decoupling or another mechanism to make Arizona's proposed 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. We cannot predict if the ACC will allow UNS Electric and other affected utilities to adopt the use of decoupling or other mechanisms.



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

The following table sets forth, by level within the fair value hierarchy, UNS Electric's financial assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2010. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

|                                       | Quoted Prices<br>in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) |   | UNS Electric<br>Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) |     | Significant<br>Unobservable<br>Inputs<br>(Level 3) |      | Total   |
|---------------------------------------|--|---|---|-----|--|------|---------|
|                                       |  |   |   |     |  |      |         |
| Cash Equivalents <sup>(1)</sup>       | \$   | 2 | \$  |     | \$   |      | \$ 2    |
| Energy Contracts <sup>(2)</sup>       |  |   |   | (3) |  | (16) | (19)    |
| <b>Net Total Assets (Liabilities)</b> | \$   | 2 | \$  | (3) | \$   | (16) | \$ (17) |

(1) Cash Equivalents are based on observable market prices and are comprised of the fair value of money market funds.

(2) Energy Contracts include gas swap agreements (Level 2), forward power purchase and sales contracts (Level 3), and forward power purchase contracts indexed to gas (Level 3), entered into to



reduce exposure to energy price risk. The amounts include current and non-current liabilities and are net of current and non-current assets, and are included in Derivative Instruments in the UniSource Energy balance sheet. The valuation techniques are described below.

For the nine months ended September 30, 2010, UNS Electric recorded net unrealized losses of \$8 million in net regulatory assets. This amount represents \$7 million in unrealized losses related to the change in the fair value of Level 3 forward power contracts primarily due to lower forward power prices and increased derivative volumes on forward power contracts and \$1 million in unrealized losses related to the change in fair value of Level 2 gas swaps primarily due to lower forward gas prices.

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

Derivatives valued using an aggregate pricing service or published prices that represent a consensus reporting of multiple brokers are categorized in Level 3. For both power and gas prices, UNS Electric obtains quotes from brokers, major market participants, exchanges, or industry publications as well as its own price experience from active transactions in the market. UNS Electric primarily uses one set of quotations each for power and for gas, and then uses the other sources as validation of those prices. The broker providing quotes for power prices states that the market information provided is indicative only, but believes it to be reflective of market conditions as of the time and date indicated. In addition, energy derivatives include contracts where published prices are not readily available. These include contracts for delivery periods during non-standard time blocks, contracts for delivery during only a few months of a given year when prices are quoted only for the annual average, or contracts for delivery at illiquid delivery points. In these cases, UNS Electric applies certain management assumptions to value such contracts. These assumptions include applying percentage multipliers to value non-standard time blocks, applying historical price curve relationships to calendar year quotes, and including adjustments for transmission and line losses to value contracts at illiquid delivery points. We also consider the impact of counterparty credit risk using current and historical default and recovery rates as well as our own credit risk using market credit default swap data. UNS Electric reviews these assumptions on a quarterly basis.

**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES****Liquidity Outlook**

In the first nine months of 2010, UNS Electric's capital expenditures were \$17 million. UNS Electric expects operating cash flows to fund a portion of its construction expenditures. Additional sources of funding future capital expenditures could include draws on the UNS Gas/UNS Electric Revolver, additional credit lines, the issuance of long-term debt, or capital contributions from UniSource Energy.

**Operating Cash Flow**

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

| <b>Nine Months Ended September 30,</b> | <b>2010</b>           | <b>2009</b> |
|--|-----------------------|-------------|
|  | -Millions of Dollars- |             |
| Cash provided by (used in):            |                       |             |
| Operating Activities                   | \$ 14                 | \$ 38       |
| Investing Activities                   | (17)                  | (23)        |
| Financing Activities                   | 2                     | (8)         |
| Net Increase (Decrease) in Cash        | (1)                   | 7           |
| Beginning Cash                         | 10                    | 9           |
| Ending Cash                            | \$ 9                  | \$ 16       |

Operating cash flows decreased in the first nine months of 2010 compared with the same period in 2009 due to: lower refunds of cash collateral deposits made with power and gas trading counterparties; and an increase in purchased energy costs.

**UNS Gas/UNS Electric Revolver**

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

The UNS Gas/UNS Electric Revolver contains restrictions on additional indebtedness, liens, mergers and sales of assets; it also contains a maximum leverage ratio and a minimum cash flow to interest coverage ratio for each borrower. UNS Electric expects to draw upon the UNS Gas/UNS Electric Revolver from time to time for seasonal working capital purposes, to fund a portion of its capital expenditures or to issue letters of credit to provide credit enhancement for its energy procurement and hedging activities. As of September 30, 2010, UNS Electric had \$18 million of outstanding letters of credit under the UNS Gas/UNS Electric Revolver.

**Interest Rate Risk**

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

**Senior Unsecured Notes**

UNS Electric has \$100 million of senior unsecured notes outstanding, consisting of \$50 million due in 2015 at 6.50% and \$50 million due in 2023 at 7.10%. The notes are guaranteed by UES. The note purchase agreement for UNS Electric contains certain restrictive covenants, including restrictions on transactions with affiliates, mergers, liens to secure indebtedness, restricted payments, and incurrence of indebtedness. As of September 30, 2010, UNS Electric was in compliance with the terms of its note purchase agreement.

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

There have been no significant changes in UNS Electric's contractual obligations or other commercial commitments from those reported in our 2009 Annual Report on Form 10-K other than the following purchase obligations entered into in 2010:

| Payment Due in Years<br>Ending December 31, | 2010 | 2011  | 2012 | 2013 | 2014 | 2015<br>and<br>after | Total |
|---|------|-------|------|------|------|----------------------|-------|
| - Millions of Dollars -                     |      |       |      |      |      |                      |       |
| <b>Purchase Obligations:</b>                |      |       |      |      |      |                      |       |
| Purchased Power                             | \$   | \$ 25 | \$ 7 | \$   | \$   | \$                   | \$ 32 |

**Dividends on Common Stock**

As of September 30, 2010 UNS Electric has not paid dividends to UniSource Energy. UNS Electric's ability to pay dividends will depend on the cash needs for capital expenditures and various other factors.

The note purchase agreement for UNS Electric contains restrictions on dividends. UNS Electric may pay dividends so long as (a) no default or event of default exists and (b) it could incur additional debt under the debt incurrence test. As of September 30, 2010, UNS Electric was in compliance with the terms of its note purchase agreement. See *Senior Unsecured Notes*, above.

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

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

|                                 | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---------------------------------|---|-------------|--|-------------|
|                                 | <b>2010</b>                                 | <b>2009</b> | <b>2010</b>                                | <b>2009</b> |
|                                 | - Millions of Dollars -                     |             |  |             |
| UED                             | \$ 1  | \$ 1        | \$ 3                                       | \$ 3        |
| Millennium                      | (6)   |             | (9)  | 4           |
| UniSource Energy Parent Company | (1)   | (1)         | (4)  | (4)         |
| Total Other                     | \$ (6)                                      | \$          | \$ (10)                                    | \$ 3        |

**UniSource Energy Parent Company**

UniSource Energy parent company expenses include interest expense (net of tax) related to the UniSource Energy Convertible Senior Notes and the UniSource Credit Agreement. In 2009, UniSource Energy had capital expenditures of \$8 million at the parent level related to the purchase of land and site development to construct a new headquarters building. In the first nine months of 2010, UniSource Energy's parent-level capital expenditures were \$9 million.

**UED**

In the first nine months of 2010 and 2009, UED recorded after-tax income of \$3 million related to the operation of BMGS.

In September 2010, UNS Electric received a rate order from the ACC that approves the purchase of BMGS by UNS Electric. UNS Electric expects to complete the purchase during 2011. See *UNS Electric, Factors Affecting Results of Operations, Rates, 2010 UNS Electric Rate Order*, above, for more information.

In the first quarter of 2010, UED paid a \$9 million dividend to UniSource Energy, of which \$4 million represented a return of capital distribution. In 2009, UED paid a \$30 million dividend to UniSource Energy which also represented a return of capital distribution.



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**Millennium**

Millennium recorded a \$6 million loss in the third quarter of 2010 compared with no net income in the same period last year. Millennium's results in the third quarter of 2010 include: \$5 million of income tax expense related to the write-off of deferred tax assets; and a \$1 million after-tax impairment loss related to its investments.

In the first nine months of 2010, Millennium recorded a net loss of \$9 million compared with net income of \$4 million in the same period last year. Millennium's results in the first nine months of 2010 include: \$5 million of income tax expense related to the write-off of deferred tax assets; \$4 million of after-tax impairment losses related to its investments; and an after-tax gain of less than \$1 million related to the sale of an investment. Millennium's results in the first nine months of 2009 include a \$4 million after-tax gain on the sale of its 50% interest in Sabinas.

At September 30, 2010, Millennium's investment balance was \$22 million, including a \$15 million note receivable plus interest of \$1 million, and its cash balance was \$3 million. In the first nine months of 2010, Millennium paid dividends of \$6 million to UniSource Energy compared with \$3 million in the same period last year; both represented return of capital distributions.

Millennium's financial assets and liabilities that are accounted for at fair value on a recurring basis as of September 30, 2010 consist of:

- (1) Cash Equivalents of \$1 million which are valued based on observable market prices and are comprised of the fair value of money market funds; and
- (2) Equity Investments of \$1 million which are valued, in the absence of readily ascertainable market values, based on the investment partner's valuations and comprise Millennium's equity investments in unregulated businesses.

These investments are included in Investments and Other Property - Other in the UniSource Energy balance sheet.

**CRITICAL ACCOUNTING ESTIMATES**

There have been no significant changes in our accounting policies from those disclosed in our Form 10-K for the year ended December 31, 2009.

**RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

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

The FASB issued authoritative guidance for multiple deliverable revenue arrangements that provides another alternative for determining the selling price of deliverables and eliminates the residual method of allocating consideration. In addition, this pronouncement requires expanded qualitative and quantitative disclosures and is effective for revenue arrangements entered into after January 1, 2011. We are evaluating the impact of this pronouncement.

The FASB issued amendments that require some new disclosures and clarify some existing disclosure requirements about fair value measurements. The amendments are effective for interim and annual reporting periods beginning January 1, 2010, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements, which are effective for interim and annual reporting periods beginning January 1, 2011. We will incorporate these new disclosures in our March 31, 2011 financial statements. See *Financial Statements Note 10. Fair Value Measurements* for our current fair value disclosures.

**Table of Contents****SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. UniSource Energy and TEP are including the following cautionary statements to make applicable and take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 for any forward-looking statements made by or for UniSource Energy or TEP in this Quarterly Report on Form 10-Q.

Forward-looking statements include statements concerning plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements that are not statements of historical facts.

Forward-looking statements may be identified by the use of words such as anticipates, estimates, expects, intends, plans, predicts, projects, and similar expressions. From time to time, we may publish or otherwise make available forward-looking statements of this nature. All such forward-looking statements, whether written or oral, and whether made by or on behalf of UniSource Energy or TEP, are expressly qualified by these cautionary statements and any other cautionary statements which may accompany the forward-looking statements. In addition, UniSource Energy and TEP disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of this report.

Forward-looking statements involve risks and uncertainties, which could cause actual results or outcomes to differ materially from those expressed in the forward-looking statements. We express our expectations, beliefs and projections in good faith and believe them to have a reasonable basis. However, we make no assurances that management's expectations, beliefs or projections will be achieved or accomplished. We have identified the following important factors that could cause actual results to differ materially from those discussed in our forward-looking statements. These may be in addition to other factors and matters discussed in Item 1A. Risk Factors, Item 2.

Management's Discussion and Analysis, and other parts of this report: state and federal regulatory and legislative decisions and actions, including environmental legislation and renewable energy requirements; regional economic and market conditions which could affect customer growth and energy usage; weather variations affecting energy usage; the cost of debt and equity capital and access to capital markets; the performance of the stock market and changing interest rate environment, which affect the value of the company's pension and other postretirement benefit plan assets and the related contribution requirements and expense; unexpected increases in O&M expense; resolution of pending litigation matters; changes in accounting standards; changes in critical accounting estimates; the ongoing restructuring of the electric industry; changes to long-term contracts; the cost of fuel and power supplies; and performance of TEP's generating plants.

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

The information contained in this Item identifies material changes from information included in Part II, Item 7A in UniSource Energy and TEP's Annual Report on Form 10-K for the year ended December 31, 2009 and Quarterly Reports on Form 10-Q for the period ended March 31, 2010 and June 30, 2010, in addition to the interim condensed consolidated financial statements and accompanying notes presented in Item 1 and Management's Discussion and Analysis presented in Item 2 of this Form 10-Q.

**Interest Rate Risk**

UniSource Energy, TEP, UNS Gas and UNS Electric are subject to interest rate risk resulting from changes in interest rates on their borrowings under revolving credit facilities. Revolving credit borrowings may be made on the basis of a spread over LIBOR or an Alternate Base Rate. As a result, UniSource Energy, TEP, UNS Gas and UNS Electric may experience significant volatility in the rates paid on LIBOR borrowings under their revolving credit facilities due to changes in the base rate. Each of the revolving credit facilities for UniSource Energy, TEP, UNS Gas and UNS Electric expires in August 2011. We are in the process of refinancing each of these facilities and expect to complete the transactions before the end of 2010. The associated interest rate spreads are expected to increase approximately 150 to 175 basis points over current levels.

TEP is also exposed to interest rate risk resulting from changes in interest rates on certain of its variable rate debt obligations. At September 30, 2010, TEP had \$329 million in tax-exempt variable rate debt outstanding. The interest rates on TEP's tax-exempt variable rate debt are reset weekly by its remarketing agents. The maximum interest rate payable under the indentures for these bonds is 20%. During 2010 the average weekly interest rate ranged from 0.17% to 0.33%. Although short-term markets have been low and stable during 2010, TEP may still be subject to volatility in its tax-exempt variable rate debt. A 100 basis point increase in average interest rates on this debt, over a twelve month

period, would result in a decrease in TEP's pre-tax net income of approximately \$3 million.

**Table of Contents****Commodity Price Risk****TEP**

TEP is exposed to commodity price risk primarily relating to changes in the market price of electricity, natural gas, coal and emission allowances. This risk is mitigated through a PPFAC mechanism which fully recovers the actual retail fuel and purchased power costs incurred on a timely basis from TEP's retail customers. The commodity price risk from changes in the price of coal, electricity and emission allowances have not changed materially from the commodity price risks reported in our 2009 Annual Report on Form 10-K.

**Natural Gas**

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

**Purchases and Sales of Energy**

To manage its exposure to energy price risk, TEP enters into forward contracts to buy or sell energy at a specified price and future delivery period. Generally, TEP commits to future sales based on expected excess generating capability, forward prices and generation costs, using a diversified market approach to provide a balance between long-term and spot energy sales. TEP generally enters into forward purchases during its summer peaking periods to ensure it can meet its load and reserve requirements and account for other contracts and resource contingencies. TEP also enters into limited forward purchases and sales to optimize its resource portfolio and take advantage of locational differences in price. These positions are managed on both a volumetric and dollar basis and are closely monitored using risk management policies and procedures overseen by the Risk Management Committee.

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

| <b>Nine Months Ended Sept. 30,</b> | <b>2010</b>           | <b>2009</b> |
|------------------------------------|-----------------------|-------------|
|                                    | -Millions of Dollars- |             |
| Unrealized Gains                   | \$ 4                  | \$ 11       |

As required by fair value accounting rules, for the nine months ended September, 30, 2010, TEP considered the impact of non-performance risk in the measurement of fair value of its derivative assets and derivative liabilities net of collateral posted. The adjustment required for TEP was less than \$1 million at September 30, 2010.

**Sensitivity Analysis of Derivatives**

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

|  | <b>Unrealized Gain (Loss) of TEP's<br/>Hedging and Trading Activities</b> |               |               |                              |
|--|---|---------------|---------------|------------------------------|
|  | - Millions of Dollars -   |               |               |                              |
|  | Maturity 0  | Maturity 6    | Maturity      | Total                        |
|  | 6   | 12            | over 1 yr.    | Unrealized<br>Gain<br>(Loss) |
| Source of Fair Value at September 30, 2010         | months  | months        | months        | (Loss)                       |
| Prices actively quoted                             | \$ (1)  | \$ (5)        | \$ (3)        | \$ (9)                       |
| Prices based on models and other valuation methods |   | 1             | 2             | 3                            |
| <b>Total</b>                                       | <b>\$ (1)</b>   | <b>\$ (4)</b> | <b>\$ (1)</b> | <b>\$ (6)</b>                |



TEP uses sensitivity analysis to measure the impact of favorable and unfavorable changes in market prices on the fair value of its derivative forward contracts. Unrealized gains and losses are recorded as either a regulatory asset or regulatory liability. As contracts settle, the unrealized gains and losses are reversed and realized gains or losses are recorded to the PPFAC. The chart below summarizes the change in unrealized gains or losses if market prices increase or decrease by 10%.

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|   | - Millions of Dollars - |                 |
|---|-------------------------|-----------------|
|   | 10%<br>Increase         | 10%<br>Decrease |
| Change in Market Price as of September 30, 2010 |                         |                 |
| <b>Non-Cash Flow Hedges</b>                     |                         |                 |
| Forward gas contracts                           | \$ 3                    | \$ (3)          |
| Forward power sales and purchase contracts      |                         |                 |

**Cash Flow Hedges**

|                                  |   |     |
|----------------------------------|---|-----|
| Forward power purchase contracts | 1 | (1) |
|----------------------------------|---|-----|

**UNS Gas**

UNS Gas is subject to commodity price risk, primarily from the changes in the price of natural gas purchased for its customers. This risk is mitigated through the PGA mechanism which provides an adjustment to UNS Gas retail rates to recover the actual costs of gas and transportation.

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

| <b>Nine Months Ended September 30,</b> | <b>2010</b>           | <b>2009</b> |
|--|-----------------------|-------------|
|  | -Millions of Dollars- |             |
| Unrealized Gains (Losses)              | \$ (6)                | \$ 5        |

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

**UNS Electric**

UNS Electric is exposed to commodity price risk from changes in the price for electricity and natural gas. This risk is mitigated through a PPFAC mechanism which fully recovers the costs incurred on a timely basis.

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

| <b>Nine Months Ended September 30,</b> | <b>2010</b>           | <b>2009</b> |
|--|-----------------------|-------------|
|  | -Millions of Dollars- |             |
| Unrealized Gains (Losses)              | \$ (8)                | \$ 7        |

For UNS Electric's forward power sales and purchase contracts, a 10% decrease in market prices would result in an increase in unrealized net losses reported as net regulatory assets of \$7 million, while a 10% increase in market prices would result in a decrease in unrealized net losses reported as net regulatory assets of \$7 million.

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

**Credit Risk**

UniSource Energy is exposed to credit risk in its energy-related marketing, trading and hedging activities related to potential non-performance by counterparties.

As of September 30, 2010, TEP's credit exposure related to its wholesale marketing and gas hedging activities was approximately \$20 million. TEP's total exposure to non-investment grade or non-rated counterparties was \$7 million. At September 30, 2010, TEP had posted \$1 million in letters of credit as credit enhancements with its counterparties, and did not hold any collateral from its counterparties.

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At September 30, 2010, UNS Gas had no mark-to-market counterparty credit exposure under its supply and hedging contracts. As of September 30, 2010, UNS Gas had posted \$3 million in cash as credit enhancements with its counterparties, and did not hold any collateral from counterparties.

At September 30, 2010, UNS Electric had \$3 million of counterparty credit exposure under its supply and hedging contracts. As of September 30, 2010, UNS Electric had posted \$18 million in letters of credit with its counterparties and had not collected any collateral margin from its counterparties.

**ITEM 4. CONTROLS AND PROCEDURES**

UniSource Energy and TEP's Chief Executive Officer and Chief Financial Officer supervised and participated in UniSource Energy and TEP's evaluation of their disclosure controls and procedures as such term is defined under Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act), as of the end of the period covered by this report. Disclosure controls and procedures are controls and procedures designed to ensure that information required to be disclosed in UniSource Energy and TEP's periodic reports filed or submitted under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. These disclosure controls and procedures are also designed to ensure that information required to be disclosed by UniSource Energy and TEP in the reports that they file or submit under the Exchange Act is accumulated and communicated to management, including the principal executive and principal financial officers, or person performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based upon the evaluation performed, UniSource Energy and TEP's Chief Executive Officer and Chief Financial Officer concluded that UniSource Energy and TEP's disclosure controls and procedures are effective. While UniSource Energy and TEP continually strive to improve their disclosure controls and procedures to enhance the quality of their financial reporting, there has been no change in UniSource Energy or TEP's internal control over financial reporting during the third quarter of 2010 that has materially affected, or is reasonably likely to materially affect, UniSource Energy or TEP's internal control over financial reporting.

**PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS****Right of Way Matters**

TEP was a defendant in a class action filed in February 2009, in the United States District Court in Albuquerque, New Mexico by members of the Navajo Nation. The plaintiffs alleged, among other things, that the rights of way for defendants' transmission lines on Navajo lands were improperly granted and that the compensation paid for such rights of way was inadequate. The plaintiffs were requesting, among other things, that the transmission lines on these lands be removed. In June 2009, TEP and the other defendants filed motions to dismiss the lawsuit on procedural grounds. In March 2010, the Court granted several of the defendants' motions to dismiss and entered a final judgment dismissing the case in April 2010. The plaintiffs filed a Notice of Appeal with the Bureau of Indian Affairs (BIA) in May 2010, appealing the BIA's decision to grant the rights of way that were the subject of the now-dismissed complaint. In June 2010, the BIA found that the Notice of Appeal failed to meet the minimum filing requirements. In September 2010, the plaintiffs filed new Notices of Appeal concerning the same rights of way. TEP cannot predict the outcome of these appeals.

Other than the legal proceedings described above and in *Note 6 of Notes to Consolidated Financial Statements, Commitments and Contingencies* and in *Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations*, there are no other pending material legal proceedings to which the Company is a party, other than routine litigation incidental to the business of the Company.

**ITEM 1A. RISK FACTORS**

The business and financial results of UniSource Energy and TEP are subject to numerous risks and uncertainties. The risks and uncertainties have not changed materially from those reported in our 2009 Annual Report on Form 10-K.

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

Issuer Purchases of Equity Securities None.

**ITEM 5. OTHER INFORMATION****Ratio of Earnings to Fixed Charges**

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

|                  | <b>9 Months Ended<br/>September 30,<br/>2010</b> | <b>12 Months<br/>Ended<br/>September 30<br/>2010</b> |
|------------------|--|--|
| UniSource Energy | 3.066  | 2.701  |
| TEP              | 3.255  | 2.824  |

For purposes of this computation, earnings are defined as pre-tax earnings from continuing operations before minority interest, or income/loss from equity method investments, plus interest expense and amortization of debt discount and expense related to indebtedness. Fixed charges are interest expense, including amortization of debt discount and expense on indebtedness.

**Environmental Matters****Coal Combustion Residuals**

In June, 2010, the EPA published its proposed regulations governing the handling and disposal of coal combustion residuals (CCRs), which is primarily composed of coal ash. The EPA proposes regulating CCRs as either non-hazardous waste or hazardous waste and is seeking comment on three different alternatives. The hazardous waste proposal would phase out the use of ash ponds for disposal of CCRs. The other two proposals regulate CCRs as non-hazardous waste and impose performance standards for ash disposal. One of these proposals would require retrofitting or closure of currently unlined ash ponds, while the other proposal would not require the installation of liners or pond closures.

The EPA has not yet indicated a preference for any of the alternatives. Under each of the alternatives, the proposed regulation would continue to allow CCRs to be beneficially reused or recycled as components of other products instead of placed in impoundments or landfills.

We do not know when the EPA will issue a final rule, including required compliance dates, and cannot currently predict the outcome of the EPA's actions. The financial impact to TEP, if any, cannot be determined at this time.

**EPA Information Request**

In October 2010, TEP received a request from the EPA under Section 114 of the Clean Air Act for information regarding projects at and operations of the Sundt Generating Station. Sundt is comprised of four generating units. Units 1, 2 and 3 can be operated on either gas or diesel oil. Unit 4 can be operated on either gas or coal. TEP owns and operates all four units and is responding to the request.

In April, 2009, APS received a request from the EPA under Section 114 of the Clean Air Act for information regarding projects at and operations of the Four Corners Generating Station (Four Corners). Four Corners, which is operated by APS, is comprised of five coal-fired generating units. TEP has a 7% ownership interest in Units 4 and 5, totaling 110 MW. APS responded to the request in August 2009.

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**Notice of Intent to Sue**

On May 7, 2010, APS received a Notice of Intent to Sue from Earthjustice, on behalf of several environmental organizations, related to alleged violations of the Clean Air Act at Four Corners (the Notice). The Notice alleges New Source Review-related violations and New Source Performance Standard violations. Under the Clean Air Act, a citizens group is required to provide 60 days advance notice of its intent to file a lawsuit. Within that 60-day time period, the EPA may step in and file a lawsuit regarding the allegations. If the EPA does so, the citizens group is precluded from filing its own lawsuit, but it may still intervene in the EPA's lawsuit, if it so desires. The 60-day period lapsed in early July, and the EPA did not take any action. At this time, TEP cannot predict whether or when Earthjustice might file a lawsuit.

**Regional Haze Rules**

The EPA's regional haze rules require emission controls known as Best Available Retrofit Technology (BART) for certain industrial facilities emitting air pollutants that reduce visibility. The rules call for all states to establish goals and emission reduction strategies for improving visibility in national parks and wilderness areas and to submit a state implementation plan to the EPA.

*San Juan Generating Station (San Juan)*

In June 2010, the New Mexico Environment Department (NMED) filed its proposed regional haze state implementation plan with the New Mexico Environmental Improvement Board. The plan proposes that the BART for nitrogen oxides at San Juan is a technology known as selective catalytic reduction (SCR) plus sorbent injection. PNM, the operator at San Juan, previously analyzed SCR and concluded it was not the BART and intends to vigorously challenge the NMED's proposal.

TEP's share of installing SCRs with sorbent injection is estimated to be \$171 million. This estimate is based on PNM's 2007 analysis of the cost of installation of SCR technology and more recent estimates of the cost of installing sorbent injection. Adding these technologies to San Juan would also increase operating costs at the generating station. Once the EPA approves an implementation plan for New Mexico, the San Juan participants would have five years to achieve compliance.

*Four Corners*

In October, 2010, EPA issued a proposed federal implementation plan for BART at the Four Corners. The proposed plan, if approved, would require the installation of SCRs on units 1 through 5 and baghouses on units 1 through 3. TEP has a 7% interest in units 4 and 5. TEP's estimated share of the installation cost for SCRs for units 4 and 5 is approximately \$38 million. Once the EPA finalizes the BART rule for Four Corners, the Four Corners participants would have five years to achieve compliance.

TEP cannot predict the ultimate outcome of these matters.

**ITEM 6. EXHIBITS**

See Exhibit Index.

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**SIGNATURES**

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

**UNISOURCE ENERGY CORPORATION**  
(Registrant)

Date: October 27, 2010

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

**TUCSON ELECTRIC POWER**  
**COMPANY**  
(Registrant)

Date: October 27, 2010

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

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**EXHIBIT INDEX**

|        |  |
|--------|--|
| 12 (a) | Computation of Ratio of Earnings to Fixed Charges    UniSource Energy.   |
| 12 (b) | Computation of Ratio of Earnings to Fixed Charges    TEP.  |
| 15     | Letter regarding unaudited interim financial information.  |
| 31 (a) | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act    UniSource Energy, by Paul J. Bonavia.   |
| 31 (b) | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act    UniSource Energy, by Kevin P. Larson.   |
| 31 (c) | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act    TEP, by Paul J. Bonavia.  |
| 31 (d) | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act    TEP, by Kevin P. Larson.  |
| *32    | Statements of Corporate Officers (pursuant to Section 906 of the Sarbanes-Oxley Act of 2002).  |
| *101   | The following materials from UniSource Energy Corporation    s and Tucson Electric Power Company    s Quarterly Report on Form 10-Q for the quarter ended September 30, 2010, formatted in XBRL (Extensible Business Reporting Language):  |
|        | (a) UniSource Energy Corporation    s (i) Comparative Condensed Consolidated Statement of Income, (ii) Comparative Condensed Consolidated Statement of Cash Flows, (iii) Comparative Condensed Consolidated Balance Sheets, (iv) Condensed Statement of Changes in Stockholder    s Equity and Comprehensive Income; and |
|        | (b) Notes to Condensed Consolidated Financial Statements, tagged as blocks of text.  |
| *      | Not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.   |
| **     | Previously filed as indicated and incorporated by reference.   |