

TUCSON ELECTRIC POWER CO
Form 10-Q
November 02, 2012
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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, 2012

OR

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

For the transition period from _____ to _____.

Commission

Registrant; State of Incorporation;

IRS Employer

File Number
1-13739

Address; and Telephone Number
UNS ENERGY CORPORATION

Identification Number
86-0786732

(An Arizona Corporation)

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As of October 22, 2012, 43,384,111 shares of UNS Energy Corporation Common Stock, no par value (the only class of Common Stock), were outstanding. As of October 22, 2012, Tucson Electric Power Company had 32,139,434 shares of common stock outstanding, no par value, all of which were held by UNS Energy Corporation.

This combined Form 10-Q is separately filed by UNS Energy Corporation and Tucson Electric Power Company. Information contained in this document relating to Tucson Electric Power Company is filed by UNS 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 UNS 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 2012 third quarter report on Form 10-Q are defined below:

| | |
|----------------------------------|---|
| 1992 Mortgage | TEP's Indenture of Mortgage and Deed of Trust, dated as of December 1, 1992, to the Bank of New York Mellon, successor trustee, as supplemented |
| 2008 TEP Rate Order | A rate order issued by the Arizona Corporation Commission resulting in a new retail rate structure for TEP, effective December 1, 2008 |
| 2010 TEP Reimbursement Agreement | Reimbursement Agreement, dated December 14, 2010, between TEP, as borrower, and a financial institution |
| ACC | Arizona Corporation Commission |
| AFUDC | Allowance for Funds Used During Construction |
| APS | Arizona Public Service Company |
| Base Rates | The portion of TEP's and UNS Electric's Retail Rates attributed to generation, transmission, distribution costs, and customer charge; and UNS Gas' delivery costs and customer charge. Base Rates exclude costs that are passed through to customers for fuel and purchased energy costs. |
| BART | Best Available Retrofit Technology |
| BHP | BHP Minerals International, Inc. |
| BMGS | Black Mountain Generating Station |
| 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 megawatts |
| CCRs | Coal Combustion Residuals |
| Circuit Court | United States Court of Appeals |
| CC&N | Certificate of Convenience and Necessity |
| Common Stock Company | UNS Energy Corporation's common stock, without par value UNS Energy Corporation and its subsidiaries |
| Convertible Senior Notes | UNS Energy Corporation's 4.5% Convertible Senior Notes |
| 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 |
| ECA | Environmental Compliance Adjustor |
| EEIP | Energy Efficiency Implementation Plan |
| Electric EE Standards | Electric Energy Efficiency Standards |
| Energy | The amount of power produced over a given period of time measured in megawatt-hours |
| EPA | Environmental Protection Agency |
| EPS | Earnings Per Share |
| ESP | Electric Service Providers |
| FERC | Federal Energy Regulatory Commission |

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| | |
|---------------------|---|
| FIP | Federal Implementation Plan |
| Four Corners | Four Corners Generating Station |
| GAAP | Generally Accepted Accounting Principles |
| Gas EE Standards | Gas Energy Efficiency Standards |
| GBtu | Billion British thermal units |
| GHG | Green House Gases |
| GWh | Gigawatt-hour(s) |
| Heating Degree Days | An index used to measure the impact of weather on energy usage calculated by subtracting the average of the high and low daily temperatures from 65 |
| | Internal Revenue Service |
| IRS | |
| kV | Kilo-volt |
| kWh | Kilowatt-hour(s) |
| LFCR | Lost Fixed Cost Recovery Mechanism |
| LOC | Letter of Credit |
| LIBOR | London Interbank Offered Rate |
| Luna | Luna Generating Station |

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| Millennium | Millennium Energy Holdings, Inc., a wholly-owned subsidiary of UNS Energy Corporation |
| MMBtu | Million British thermal units |
| Mortgage Bonds | Mortgage Bonds issued under the 1992 Mortgage |
| MW | Megawatt(s) |
| MWh | Megawatt-hour(s) |
| Navajo | Navajo Generating Station |
| O&M | Operations and Maintenance Expense |
| NSP | Negotiated Sales Program |
| NTUA | Navajo Tribal Utility Authority |
| NOx | Nitrogen Oxide |
| PGA | Purchased Gas Adjustor, a Retail Rate mechanism designed to recover the cost of gas purchased for retail gas customers |
| PNM | Public Service Company of New Mexico |
| PNMR | PNM Resources, Incorporated, PNM's parent company |
| PPA | Power Purchase Agreement |
| PPFAC | Purchased Power and Fuel Adjustment Clause |
| PSD | Prevention of Significant Deterioration |
| RCRA | Resource Conservation and Recovery Act |
| REC | Renewable Energy Credit |
| RES | Renewable Energy Standard |
| Retail Rates | Rates designed to allow a regulated utility an opportunity to recover its reasonable operating and capital costs and earn a return on its utility plant in service |
| Rules | Retail Electric Competition Rules established by the ACC in 1999 |
| San Juan | San Juan Generating Station |
| SERP | Supplemental Executive Retirement Plan |
| SCR | Selective Catalytic Reduction |
| SES | Southwest Energy Solutions, a wholly-owned subsidiary of Millennium |
| SJCC | San Juan Coal Company |
| SMCRA | Surface Mine Control and Reclamation Act |
| SO ₂ | Sulfur Dioxide |
| Springerville | Springerville Generating Station |
| Springerville Common Facilities | Facilities at Springerville used in common by all four Springerville units |
| Springerville Common Facilities Leases | Leveraged lease arrangements relating to an undivided one-half interest in certain Springerville Common Facilities |
| Springerville Unit 1 | Unit 1 of the Springerville Generating Station |
| Springerville Unit 1 Leases | Leveraged lease 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 |

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|-------------------------------|---|
| Springerville Unit 3 | Unit 3 of the Springerville Generating Station |
| Springerville Unit 4 | Unit 4 of the Springerville Generating Station |
| SRP | Salt River Project Agricultural Improvement and Power District |
| Sundt | H. Wilson Sundt Generating Station |
| Sundt Unit 4 | Unit 4 of the H. Wilson Sundt Generating Station |
| TEP | Tucson Electric Power Company, the principal subsidiary of UNS Energy Corporation |
| TEP Credit Agreement | Second Amended and Restated Credit Agreement between TEP and a syndicate of banks, dated as of November 9, 2010 (as amended) |
| TEP Letter of Credit Facility | Letter of credit facility under the TEP Credit Agreement |
| TEP Revolving Credit Facility | Revolving credit facility under the TEP Credit Agreement |
| Therm | A unit of heating value equivalent to 100,000 Btus |
| Tri-State | Tri-State Generation and Transmission Association, Inc. |
| UED | UniSource Energy Development Company, a wholly-owned subsidiary of UNS Energy Corporation |
| UES | UniSource Energy Services, Inc., an intermediate holding company established to own the operating companies UNS Gas and UNS Electric |

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|-------------------------------|---|
| UNS Credit Agreement | Second Amended and Restated Credit Agreement between UNS Energy Corporation and a syndicate of banks, dated as of November 9, 2010 (as amended) |
| UNS Energy | UNS Energy Corporation (formally known as 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 Second Amended and Restated Credit Agreement among UNS Gas and UNS Electric as borrowers, UES as guarantor, and a syndicate of banks, dated as of November 9, 2010 (as amended) |

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of

UNS Energy Corporation:

We have reviewed the accompanying condensed consolidated balance sheet of UNS Energy Corporation and its subsidiaries (the Company) as of September 30, 2012, and the related condensed consolidated statements of income for the three and nine-month periods ended September 30, 2012 and 2011, the condensed consolidated statements of comprehensive income for the three and nine-month periods ended September 30, 2012 and 2011, the condensed consolidated statement of changes in stockholders' equity for the nine-month period ended September 30, 2012, and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2012 and 2011. 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, 2011, 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 27, 2012, 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, 2011, 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

November 2, 2012

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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, 2012, and the related condensed consolidated statements of income for the three and nine-month periods ended September 30, 2012 and 2011, the condensed consolidated statements of comprehensive income for the three and nine-month periods ended September 30, 2012 and 2011, the condensed consolidated statement of changes in stockholder s equity for the nine-month period ended September 30, 2012, and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2012 and 2011. 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, 2011, 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 presented herein), and in our report dated February 27, 2012, 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, 2011, 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

November 2, 2012

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

UNS ENERGY CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

| Three Months Ended September 30, 2012 | | 2011 | | Nine Months Ended September 30, 2012 | | 2011 |
|---|----------------|---|--|--|------------------|----------------------------|
| | | (Unaudited) | | | | (Unaudited) |
| | | -Thousands of Dollars- | | | | -Thousands of Dollars- |
| | | (Except Per Share Amounts) | | | | (Except Per Share Amounts) |
| Operating Revenues | | | | | | |
| \$ 353,473 | \$ 363,385 | Electric Retail Sales | | \$ 850,975 | \$ 856,216 | |
| 32,494 | 41,847 | Electric Wholesale Sales | | 98,282 | 121,506 | |
| 15,407 | 16,831 | Gas Retail Sales | | 85,621 | 99,041 | |
| 35,887 | 28,884 | Other Revenues | | 88,427 | 88,624 | |
| 437,261 | 450,947 | Total Operating Revenues | | 1,123,305 | 1,165,387 | |
| Operating Expenses | | | | | | |
| 92,873 | 98,962 | Fuel | | 245,933 | 252,103 | |
| 60,238 | 88,734 | Purchased Energy | | 174,891 | 233,344 | |
| 4,500 | (1,354) | Transmission | | 10,738 | 4,612 | |
| 18,076 | (3,576) | Increase (Decrease) to Reflect PPFAC/PGA Recovery Treatment | | 29,730 | (5,174) | |
| 175,687 | 182,766 | Total Fuel and Purchased Energy | | 461,292 | 484,885 | |
| 98,346 | 90,781 | Operations and Maintenance | | 283,587 | 281,888 | |
| 35,145 | 33,553 | Depreciation | | 105,319 | 99,653 | |
| 9,069 | 7,882 | Amortization | | 26,845 | 22,513 | |
| 12,605 | 12,205 | Taxes Other Than Income Taxes | | 37,385 | 36,579 | |
| 330,852 | 327,187 | Total Operating Expenses | | 914,428 | 925,518 | |
| 106,409 | 123,760 | Operating Income | | 208,877 | 239,869 | |
| Other Income (Deductions) | | | | | | |
| 340 | 1,919 | Interest Income | | 981 | 3,739 | |
| 1,726 | 1,678 | Other Income | | 5,729 | 7,155 | |
| (886) | (1,412) | Other Expense | | (1,761) | (2,830) | |
| 1,180 | 2,185 | Total Other Income (Deductions) | | 4,949 | 8,064 | |
| Interest Expense | | | | | | |
| 17,074 | 17,945 | Long-Term Debt | | 53,811 | 54,240 | |
| 8,507 | 10,248 | Capital Leases | | 25,105 | 30,108 | |
| 233 | (88) | Other Interest Expense, Net of Interest Capitalized | | 66 | (1,118) | |
| 25,814 | 28,105 | Total Interest Expense | | 78,982 | 83,230 | |
| 81,775 | 97,840 | Income Before Income Taxes | | 134,844 | 164,703 | |

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|--|------------------|-------------------------------------|------------------|-------------------|
| 31,111 | 38,128 | Income Tax Expense | 51,430 | 62,916 |
| \$ 50,664 | \$ 59,712 | Net Income | \$ 83,414 | \$ 101,787 |
| Weighted-Average Shares of Common Stock Outstanding (000) | | | | |
| 41,446 | 37,053 | Basic | 39,983 | 36,930 |
| 41,863 | 41,777 | Diluted | 41,719 | 41,577 |
| Earnings Per Share | | | | |
| \$ 1.22 | \$ 1.61 | Basic | \$ 2.09 | \$ 2.76 |
| \$ 1.21 | \$ 1.46 | Diluted | \$ 2.03 | \$ 2.53 |
| \$ 0.43 | \$ 0.42 | Dividends Declared Per Share | \$ 1.29 | \$ 1.26 |

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**UNS ENERGY CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

| Three Months Ended September 30, 2012 2011 (Unaudited) -Thousands of Dollars- | | | Nine Months Ended September 30, 2012 2011 (Unaudited) -Thousands of Dollars- | |
|--|-----------|---|---|------------|
| | | Comprehensive Income | | |
| \$ 50,664 | \$ 59,712 | Net Income | \$ 83,414 | \$ 101,787 |
| | | Other Comprehensive Income (Loss) | | |
| (800) | (2,060) | Unrealized (Loss) on Cash Flow Hedges, net of \$522 and \$1,347 income taxes | | |
| | | net of \$1,219 and \$2,109 income taxes | (1,864) | (3,222) |
| 1,170 | 1,102 | Reclassification of Realized Losses on Cash Flow Hedges to Net Income, net of \$(766) and \$(722) income taxes | | |
| | | net of \$(1,640) and \$(1,153) income taxes | 2,505 | 1,761 |
| 55 | 74 | Supplemental Executive Retirement Plan (SERP) Benefit Adjustments, net of \$(34) and \$(46) income taxes | | |
| | | net of \$(50) and \$(141) income taxes | 219 | 223 |
| 425 | (884) | Total Other Comprehensive Income (Loss), Net of Income Taxes | 860 | (1,238) |
| \$ 51,089 | \$ 58,828 | Total Comprehensive Income | \$ 84,274 | \$ 100,549 |

See Notes to Condensed Consolidated Financial Statements.

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

| | Nine Months Ended September 30, | |
|--|------------------------------------|------------------|
| | 2012 | 2011 |
| | (Unaudited) | |
| | -Thousands of Dollars- | |
| Cash Flows from Operating Activities | | |
| Cash Receipts from Electric Retail Sales | \$ 894,195 | \$ 876,960 |
| Cash Receipts from Electric Wholesale Sales | 107,854 | 137,029 |
| Cash Receipts from Gas Retail Sales | 114,055 | 125,913 |
| Cash Receipts from Operating Springerville Units 3 & 4 | 75,715 | 80,558 |
| Cash Receipts from Gas Wholesale Sales | 565 | 12,404 |
| Interest Received | 2,884 | 5,400 |
| Income Tax Refunds Received | 307 | 3,819 |
| Performance Deposits Received | 200 | 6,340 |
| Other Cash Receipts | 18,610 | 16,830 |
| Fuel Costs Paid | (243,638) | (212,791) |
| Payment of Operations and Maintenance Costs | (203,539) | (220,625) |
| Purchased Energy Costs Paid | (189,927) | (246,452) |
| Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized | (128,513) | (123,166) |
| Wages Paid, Net of Amounts Capitalized | (94,815) | (92,924) |
| Interest Paid, Net of Amounts Capitalized | (52,593) | (56,060) |
| Capital Lease Interest Paid | (27,895) | (31,558) |
| Performance Deposits Paid | (200) | (3,840) |
| Wholesale Gas Costs Paid | | (11,822) |
| Income Taxes Paid | | (700) |
| Other Cash Payments | (5,127) | (4,828) |
| Net Cash Flows Operating Activities | 268,138 | 260,487 |
| Cash Flows from Investing Activities | | |
| Return of Investments in Springerville Lease Debt | 19,278 | 38,353 |
| Proceeds from Note Receivable | 12,500 | |
| Insurance Proceeds for Replacement Assets | 2,875 | |
| Proceeds from Sale of Land and Buildings | | 2,512 |
| Other Cash Receipts | 14,484 | 11,050 |
| Capital Expenditures | (232,036) | (263,153) |
| Purchase of Intangibles Renewable Energy Credits | (7,554) | (4,102) |
| Deposit San Juan Mine Reclamation Trust | (1,107) | |
| Other Cash Payments | (232) | (578) |
| Net Cash Flows Investing Activities | (191,792) | (215,918) |
| Cash Flows from Financing Activities | | |
| Proceeds from Borrowings Under Revolving Credit Facilities | 342,000 | 238,000 |
| Proceeds from Issuance of Long-Term Debt | 149,513 | 91,080 |
| Proceeds from Stock Options Exercised | 3,529 | 7,487 |
| Other Cash Receipts | 2,935 | 3,057 |
| Repayments of Borrowings Under Revolving Credit Facilities | (346,000) | (189,000) |
| Payments of Capital Lease Obligations | (89,452) | (74,381) |
| Common Stock Dividends Paid | (51,852) | (46,382) |
| Repayments of Long-Term Debt | (9,341) | (79,665) |

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|---|-------------------|------------------|
| Payment of Debt Issue/Retirement Costs | (3,349) | (759) |
| Other Cash Payments | (718) | (1,168) |
| Net Cash Flows Financing Activities | (2,735) | (51,731) |
| Net Increase (Decrease) in Cash and Cash Equivalents | 73,611 | (7,162) |
| Cash and Cash Equivalents, Beginning of Year | 76,390 | 67,599 |
| Cash and Cash Equivalents, End of Period | \$ 150,001 | \$ 60,437 |

See Note 12 for supplemental cash flow information.

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**UNS ENERGY CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS**

| | September 30, 2012 | December 31, 2011 |
|---|------------------------|----------------------|
| | (Unaudited) | |
| | -Thousands of Dollars- | |
| ASSETS | | |
| Utility Plant | | |
| Plant in Service | \$ 4,954,791 | \$ 4,856,108 |
| Utility Plant Under Capital Leases | 582,669 | 582,669 |
| Construction Work in Progress | 122,017 | 89,749 |
| Total Utility Plant | 5,659,477 | 5,528,526 |
| Less Accumulated Depreciation and Amortization | (1,908,634) | (1,869,300) |
| Less Accumulated Amortization of Capital Lease Assets | (490,325) | (476,963) |
| Total Utility Plant Net | 3,260,518 | 3,182,263 |
| Investments and Other Property | | |
| Investments in Lease Debt and Equity | 36,375 | 65,829 |
| Other | 33,910 | 34,205 |
| Total Investments and Other Property | 70,285 | 100,034 |
| Current Assets | | |
| Cash and Cash Equivalents | 150,001 | 76,390 |
| Accounts Receivable - Customer | 120,286 | 98,633 |
| Unbilled Accounts Receivable | 57,675 | 51,464 |
| Allowance for Doubtful Accounts | (6,767) | (5,572) |
| Materials and Supplies | 90,272 | 82,649 |
| Fuel Inventory | 58,678 | 33,263 |
| Deferred Income Taxes - Current | 63,722 | 23,158 |
| Regulatory Assets - Current | 56,598 | 97,056 |
| Investments in Lease Debt | 9,356 | |
| Derivative Instruments | 7,412 | 11,966 |
| Other | 20,960 | 32,577 |
| Total Current Assets | 628,193 | 501,584 |
| Regulatory and Other Assets | | |
| Regulatory Assets - Noncurrent | 155,808 | 173,199 |
| Other Assets | 32,419 | 32,199 |
| Total Regulatory and Other Assets | 188,227 | 205,398 |
| Total Assets | \$ 4,147,223 | \$ 3,989,279 |

See Notes to Condensed Consolidated Financial Statements.

(Continued)

Table of Contents**UNS ENERGY CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS**

| | September 30, 2012 | December 31, 2011 |
|--|------------------------|----------------------|
| | (Unaudited) | |
| | -Thousands of Dollars- | |
| CAPITALIZATION AND OTHER LIABILITIES | | |
| Capitalization | | |
| Common Stock Equity | \$ 1,075,783 | \$ 888,474 |
| Capital Lease Obligations | 260,569 | 352,720 |
| Long-Term Debt | 1,516,410 | 1,517,373 |
| Total Capitalization | 2,852,762 | 2,758,567 |
| Current Liabilities | | |
| Current Obligations Under Capital Leases | 90,343 | 77,482 |
| Borrowing Under Revolving Credit Facilities | | 10,000 |
| Accounts Payable Trade | 90,367 | 109,760 |
| Accrued Taxes Other than Income Taxes | 58,475 | 41,997 |
| Interest Accrued | 25,285 | 38,302 |
| Accrued Employee Expenses | 20,714 | 25,660 |
| Regulatory Liabilities Current | 47,809 | 41,911 |
| Customer Deposits | 33,497 | 32,485 |
| Derivative Instruments | 18,306 | 36,467 |
| Other | 11,221 | 8,455 |
| Total Current Liabilities | 396,017 | 422,519 |
| Deferred Credits and Other Liabilities | | |
| Deferred Income Taxes Noncurrent | 390,045 | 300,326 |
| Regulatory Liabilities Noncurrent | 270,636 | 234,945 |
| Pension and Other Postretirement Benefits | 126,688 | 139,356 |
| Derivative Instruments | 13,520 | 20,403 |
| Other | 97,555 | 113,163 |
| Total Deferred Credits and Other Liabilities | 898,444 | 808,193 |
| Commitments, Contingencies, and Proposed Environmental Matters (Note 6) | | |
| Total Capitalization and Other Liabilities | \$ 4,147,223 | \$ 3,989,279 |

See Notes to Condensed Consolidated Financial Statements.

(Concluded)

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

| | Common Shares Outstanding* | Common Stock | Accumulated Earnings (Unaudited) -Thousands of Dollars- | Accumulated Other Comprehensive Loss | Total Stockholders Equity |
|---|----------------------------------|-------------------|--|---|---------------------------------|
| Balances at December 31, 2011 | 36,918 | \$ 725,903 | \$ 172,655 | \$ (10,084) | \$ 888,474 |
| Comprehensive Income 2012 Year-to-Date Net Income | | | 83,414 | | 83,414 |
| Other Comprehensive Income, net of \$(471) income taxes | | | | 860 | 860 |
| Total Comprehensive Income | | | | | 84,274 |
| Dividends, Including Non-Cash Dividend Equivalents | | | (52,385) | | (52,385) |
| Shares Issued on Conversion of Notes and Related Tax Effect | 4,262 | 149,805 | | | 149,805 |
| Shares Issued for Stock Options | 130 | 3,470 | | | 3,470 |
| Shares Issued Under Performance Share Awards | 31 | | | | |
| Other | | 2,145 | | | 2,145 |
| Balances at September 30, 2012 | 41,341 | \$ 881,323 | \$ 203,684 | \$ (9,224) | \$ 1,075,783 |

* UNS Energy has 75 million authorized shares of Common Stock.
See Notes to Condensed Consolidated Financial Statements.

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

| Three Months Ended | | | Nine Months Ended | | |
|----------------------------------|------------------|---|--------------------------|------------------|--|
| September 30, | | | September 30, | | |
| 2012 | | | 2012 | | |
| 2011 | | | 2011 | | |
| (Unaudited) | | | (Unaudited) | | |
| - Thousands of Dollars - | | | - Thousands of Dollars - | | |
| Operating Revenues | | | | | |
| \$ 302,893 | \$ 308,924 | Electric Retail Sales | \$ 716,993 | \$ 714,278 | |
| 25,448 | 29,608 | Electric Wholesale Sales | 77,488 | 96,623 | |
| 38,569 | 31,313 | Other Revenues | 95,826 | 93,765 | |
| 366,910 | 369,845 | Total Operating Revenues | 890,307 | 904,666 | |
| Operating Expenses | | | | | |
| 88,402 | 95,977 | Fuel | 237,930 | 246,563 | |
| 27,576 | 40,509 | Purchased Power | 62,064 | 84,189 | |
| 1,914 | (4,266) | Transmission | 4,277 | (2,339) | |
| 20,025 | 1,115 | Increase (Decrease) to Reflect PPFAC Recovery Treatment | 25,150 | (5,146) | |
| 137,917 | 133,335 | Total Fuel and Purchased Energy | 329,421 | 323,267 | |
| 86,942 | 79,837 | Operations and Maintenance | 248,092 | 246,423 | |
| 27,644 | 26,541 | Depreciation | 82,656 | 78,124 | |
| 10,001 | 8,798 | Amortization | 29,621 | 25,282 | |
| 10,327 | 9,855 | Taxes Other Than Income Taxes | 30,325 | 29,803 | |
| 272,831 | 258,366 | Total Operating Expenses | 720,115 | 702,899 | |
| 94,079 | 111,479 | Operating Income | 170,192 | 201,767 | |
| Other Income (Deductions) | | | | | |
| 28 | 1,666 | Interest Income | 97 | 2,983 | |
| 1,553 | 229 | Other Income | 4,860 | 4,597 | |
| (1,965) | (2,754) | Other Expense | (5,084) | (7,751) | |
| (384) | (859) | Total Other Income (Deductions) | (127) | (171) | |
| Interest Expense | | | | | |
| 13,268 | 12,081 | Long-Term Debt | 40,562 | 36,493 | |
| 8,507 | 10,248 | Capital Leases | 25,105 | 30,107 | |
| 201 | (44) | Other Interest Expense, Net of Interest Capitalized | (43) | (881) | |
| 21,976 | 22,285 | Total Interest Expense | 65,624 | 65,719 | |
| 71,719 | 88,335 | Income Before Income Taxes | 104,441 | 135,877 | |
| 27,150 | 34,423 | Income Tax Expense | 39,423 | 52,104 | |
| \$ 44,569 | \$ 53,912 | Net Income | \$ 65,018 | \$ 83,773 | |

See Notes to Condensed Consolidated Financial Statements.

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

| Three Months Ended September 30, 2012 2011 (Unaudited) | | | Nine Months Ended September 30, 2012 2011 (Unaudited) | |
|--|-----------|---|---|-----------|
| - Thousands of Dollars - | | | - Thousands of Dollars - | |
| | | Comprehensive Income | | |
| \$ 44,569 | \$ 53,912 | Net Income | \$ 65,018 | \$ 83,773 |
| | | Other Comprehensive Income (Loss) | | |
| | | Unrealized (Loss) on Cash Flow Hedges, net of \$446 and \$1,326 income taxes | | |
| (682) | (2,027) | | | |
| | | net of \$1,011 and \$2,088 income taxes | (1,545) | (3,190) |
| 1,147 | 1,102 | Reclassification of Realized Losses on Cash Flow Hedges to Net Income, net of \$(750) and \$(722) income taxes | | |
| | | net of \$(1,595) and \$(1,153) income taxes | 2,436 | 1,761 |
| 55 | 74 | SERP Benefit Adjustments, net of \$(34) and \$(46) income taxes | | |
| | | net of \$(50) and \$(141) income taxes | 219 | 223 |
| 520 | (851) | Total Other Comprehensive Income (Loss), Net of Income Taxes | 1,110 | (1,206) |
| \$ 45,089 | \$ 53,061 | Total Comprehensive Income | \$ 66,128 | \$ 82,567 |

See Notes to Condensed Consolidated Financial Statements.

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

| | Nine Months Ended September 30, | |
|--|------------------------------------|------------------|
| | 2012 | 2011 |
| | (Unaudited) | |
| | -Thousands of Dollars- | |
| Cash Flows from Operating Activities | | |
| Cash Receipts from Electric Retail Sales | \$ 748,936 | \$ 723,107 |
| Cash Receipts from Electric Wholesale Sales | 89,902 | 114,061 |
| Cash Receipts from Operating Springerville Units 3 & 4 | 75,715 | 80,558 |
| Cash Receipts from Gas Wholesale Sales | 153 | 11,825 |
| Reimbursement of Affiliate Charges | 16,783 | 13,928 |
| Interest Received | 2,014 | 5,361 |
| Income Tax Refunds Received | 200 | 4,360 |
| Performance Deposits Received | 200 | 1,640 |
| Other Cash Receipts | 14,328 | 12,466 |
| Fuel Costs Paid | (237,698) | (208,675) |
| Payment of Operations and Maintenance Costs | (196,328) | (215,896) |
| Taxes Other Than Income Taxes Paid, Net of Amounts Capitalized | (99,249) | (93,444) |
| Wages Paid, Net of Amounts Capitalized | (77,820) | (76,739) |
| Purchased Power Costs Paid | (60,684) | (82,321) |
| Interest Paid, Net of Amounts Capitalized | (35,728) | (34,161) |
| Capital Lease Interest Paid | (27,893) | (31,558) |
| Income Taxes Paid | (1,796) | (2,346) |
| Performance Deposit Payments | (200) | (1,640) |
| Wholesale Gas Cost Paid | | (11,822) |
| Other Cash Payments | (3,684) | (3,160) |
| Net Cash Flows Operating Activities | 207,151 | 205,544 |
| Cash Flows from Investing Activities | | |
| Return of Investments in Springerville Lease Debt | 19,278 | 38,353 |
| Insurance Proceeds for Replacement Assets | 2,875 | |
| Other Cash Receipts | 9,207 | 6,648 |
| Capital Expenditures | (196,429) | (193,714) |
| Purchase of Intangibles Renewable Energy Credits | (6,436) | (4,000) |
| Deposit San Juan Mine Reclamation Trust | (1,107) | |
| Other Cash Payments | | (558) |
| Net Cash Flows Investing Activities | (172,612) | (153,271) |
| Cash Flows from Financing Activities | | |
| Proceeds from Borrowings Under Revolving Credit Facility | 189,000 | 120,000 |
| Proceeds from Issuance of Long-Term Debt | 149,513 | 11,080 |
| Other Cash Receipts | 1,292 | 1,051 |
| Repayments of Borrowings Under Revolving Credit Facility | (199,000) | (115,000) |
| Payments of Capital Lease Obligations | (89,452) | (74,343) |
| Repayments of Long-Term Debt | (6,535) | |
| Payment of Debt Issue/Retirement Costs | (3,349) | |
| Other Cash Payments | (530) | (1,019) |
| Net Cash Flows Financing Activities | 40,939 | (58,231) |

| | | |
|---|-------------------|------------------|
| Net Increase (Decrease) in Cash and Cash Equivalents | 75,478 | (5,958) |
| Cash and Cash Equivalents, Beginning of Year | 27,718 | 19,983 |
| Cash and Cash Equivalents, End of Period | \$ 103,196 | \$ 14,025 |

See Note 12 for supplemental cash flow information.

See Notes to Condensed Consolidated Financial Statements.

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

| | September 30, 2012 | December 31, 2011 |
|---|------------------------|----------------------|
| | (Unaudited) | |
| | -Thousands of Dollars- | |
| ASSETS | | |
| Utility Plant | | |
| Plant in Service | \$ 4,300,923 | \$ 4,222,236 |
| Utility Plant Under Capital Leases | 582,669 | 582,669 |
| Construction Work in Progress | 103,547 | 76,517 |
| Total Utility Plant | 4,987,139 | 4,881,422 |
| Less Accumulated Depreciation and Amortization | (1,775,837) | (1,753,807) |
| Less Accumulated Amortization of Capital Lease Assets | (490,325) | (476,963) |
| Total Utility Plant Net | 2,720,977 | 2,650,652 |
| Investments and Other Property | | |
| Investments in Lease Debt and Equity | 36,375 | 65,829 |
| Other | 32,591 | 32,313 |
| Total Investments and Other Property | 68,966 | 98,142 |
| Current Assets | | |
| Cash and Cash Equivalents | 103,196 | 27,718 |
| Accounts Receivable - Customer | 101,178 | 73,612 |
| Unbilled Accounts Receivable | 47,988 | 32,386 |
| Allowance for Doubtful Accounts | (4,836) | (3,766) |
| Materials and Supplies | 77,782 | 70,749 |
| Accounts Receivable - Due from Affiliates | 4,379 | 4,049 |
| Fuel Inventory | 58,396 | 32,981 |
| Deferred Income Taxes - Current | 53,134 | 21,678 |
| Regulatory Assets - Current | 41,477 | 71,747 |
| Investments in Lease Debt | 9,356 | |
| Other | 18,807 | 15,192 |
| Total Current Assets | 510,857 | 346,346 |
| Regulatory and Other Assets | | |
| Regulatory Assets - Noncurrent | 145,512 | 157,386 |
| Other Assets | 25,733 | 25,135 |
| Total Regulatory and Other Assets | 171,245 | 182,521 |
| Total Assets | \$ 3,472,045 | \$ 3,277,661 |

See Notes to Condensed Consolidated Financial Statements.

(Continued)

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

| | September 30, 2012 | December 31, 2011 |
|--|------------------------|----------------------|
| | (Unaudited) | |
| | -Thousands of Dollars- | |
| CAPITALIZATION AND OTHER LIABILITIES | | |
| Capitalization | | |
| Common Stock Equity | \$ 861,071 | \$ 824,943 |
| Capital Lease Obligations | 260,569 | 352,720 |
| Long-Term Debt | 1,223,410 | 1,080,373 |
| Total Capitalization | 2,345,050 | 2,258,036 |
| Current Liabilities | | |
| Current Obligations Under Capital Leases | 90,343 | 77,482 |
| Borrowing Under Revolving Credit Facility | | 10,000 |
| Accounts Payable Trade | 74,710 | 84,509 |
| Accounts Payable Due to Affiliates | 2,811 | 4,827 |
| Accrued Taxes Other than Income Taxes | 48,865 | 32,155 |
| Interest Accrued | 23,447 | 30,877 |
| Accrued Employee Expenses | 17,720 | 22,099 |
| Customer Deposits | 24,337 | 23,743 |
| Regulatory Liabilities Current | 24,028 | 23,702 |
| Derivative Instruments | 5,506 | 9,040 |
| Other | 38,238 | 5,957 |
| Total Current Liabilities | 350,005 | 324,391 |
| Deferred Credits and Other Liabilities | | |
| Deferred Income Taxes Noncurrent | 335,936 | 263,225 |
| Regulatory Liabilities Noncurrent | 233,583 | 200,599 |
| Pension and Other Postretirement Benefits | 119,401 | 130,660 |
| Derivative Instruments | 11,226 | 14,142 |
| Other | 76,844 | 86,608 |
| Total Deferred Credits and Other Liabilities | 776,990 | 695,234 |
| Commitments, Contingencies, and Proposed Environmental Matters (Note 6) | | |
| Total Capitalization and Other Liabilities | \$ 3,472,045 | \$ 3,277,661 |

See Notes to Condensed Consolidated Financial Statements.

(Concluded)

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

| | Common Stock | Capital Stock Expense | Accumulated Deficit (Unaudited) | Accumulated Other Comprehensive Loss | Total Stockholder's Equity |
|---|-------------------|-----------------------------|---------------------------------------|---|----------------------------------|
| | | | -Thousands of Dollars- | | |
| Balances at December 31, 2011 | \$ 888,971 | \$ (6,357) | \$ (47,627) | \$ (10,044) | \$ 824,943 |
| Comprehensive Income 2012 Year-to-Date Net Income | | | 65,018 | | 65,018 |
| Other Comprehensive Income, net of \$(634) income taxes | | | | 1,110 | 1,110 |
| Total Comprehensive Income | | | | | 66,128 |
| Dividends Declared | | | (30,000) | | (30,000) |
| Balances at September 30, 2012 | \$ 888,971 | \$ (6,357) | \$ (12,609) | \$ (8,934) | \$ 861,071 |

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

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

TEP is a regulated public utility and UNS Energy's largest operating subsidiary, representing approximately 84% of UNS Energy's total assets as of September 30, 2012. TEP generates, transmits, and distributes electricity to approximately 406,000 retail electric customers in a 1,155 square mile area in southeastern Arizona. TEP also sells electricity to other utilities and power marketing entities, located primarily in the western United States. In addition, TEP operates Springerville 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 two regulated public utilities, UNS Gas, Inc. (UNS Gas) and UNS Electric, Inc. (UNS Electric). UNS Gas is a regulated gas distribution company, which services approximately 147,000 retail customers in Mohave, Yavapai, Coconino, and Navajo counties in northern Arizona, as well as in Santa Cruz County in southern Arizona. UNS Electric is a regulated public utility, which generates, transmits, and distributes electricity to approximately 92,000 retail customers in Mohave and Santa Cruz counties. In July 2011, UNS Electric purchased Black Mountain Generating Station (BMGS) from UED. This transaction did not impact UNS Energy's consolidated financial statements.

UED currently has no significant remaining assets.

Millennium's investments in unregulated businesses represent less than 1% of UNS Energy's assets as of September 30, 2012. See Note 11.

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

The accompanying quarterly financial statements of UNS 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 interim reporting requirements which do not include all the disclosures required by generally accepted accounting principles (GAAP) in the United States of America for audited annual financial statements. The year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by GAAP. This quarterly report should be reviewed in conjunction with UNS Energy's and TEP's 2011 Annual Report on Form 10-K.

Because weather and other factors cause seasonal fluctuations in sales, TEP's, UNS Gas's, and UNS Electric's, quarterly results are not indicative of annual operating results.

To be comparable with the 2012 balance sheet presentation, UNS Energy reclassified \$4 million and TEP reclassified \$2 million of 2011 trade receivables with credit balances from Accounts Receivable - Customer to Other Current Liabilities on the balance sheets. Also, UNS Energy and TEP reclassified \$1 million of 2011 payroll withholding taxes from Other Current Liabilities to Accrued Employee Expenses on the balance sheets.

RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board issued authoritative guidance that eliminated the option to report other comprehensive income in the statement of changes in equity. Rather, an entity must elect to present items of net income and other comprehensive income in one continuous statement or in two separate but consecutive statements. Effective in the first quarter of 2012, we elected to include two separate but consecutive statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited

We implemented accounting guidance in the first quarter of 2012 which enhances our disclosures regarding unobservable inputs in calculating the fair market value of certain assets and liabilities. The guidance requires additional quantitative and qualitative analysis of inputs when we use significant unobservable inputs to measure the fair value of our derivatives and financial instruments. See Note 9.

NOTE 2. REGULATORY MATTERS

RATES AND REGULATION

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

TEP RATE CASE

In July 2012, TEP filed a general rate case, on a cost-of-service basis, with the ACC requesting a Base Rate increase of approximately 15% to cover a revenue deficiency of \$128 million. TEP requested a 5.7% return on a fair value rate base of \$2.3 billion. TEP requested a Lost Fixed Cost Recovery (LFCR) mechanism to recover non-fuel costs that would go unrecovered due to lost kilowatt-hour (kWh) sales as a result of implementing the ACC's Electric Energy Efficiency Standards (Electric EE Standards) and the Renewable Energy Standard (RES). TEP also requested a mechanism, which would be adjusted annually, to recover the costs of complying with environmental standards required by federal or other governmental agencies between rate cases.

TEP proposed a three-year pilot program allowing for investment in energy efficiency programs to meet the Electric EE Standards in the most cost effective manner. Energy efficiency investments would be considered regulatory assets and amortized over a four-year period. TEP would earn a return on investment and recover the return and amortization expense through the existing Demand Side Management (DSM) surcharge.

UNS GAS RATE CASE

In April 2011, UNS Gas filed a general rate case, on a cost-of-service basis, with the ACC requesting a Base Rate increase of 3.8% to cover a revenue deficiency of \$5.6 million. In April 2012, the ACC approved a Base Rate increase of \$2.7 million, an increase of 1.8% over test year Base Rates, as well as a mechanism to enable UNS Gas to recover lost fixed cost revenues as a result of implementing the ACC's Gas Energy Efficiency Standards. UNS Gas expects to recognize less than \$0.1 million of revenue under the LFCR in 2012 and 2013. The ACC approved UNS Gas' 6.26% authorized return on a fair value rate base of \$253 million. The new rates became effective on May 1, 2012.

COST RECOVERY MECHANISMS

TEP Purchased Power and Fuel Adjustment Clause

In March 2012, the ACC approved a 0.77 cents per kWh Purchased Power and Fuel Adjustment Clause (PPFAC) rate, effective April 2012 and approved the elimination of the fixed Competition Transition Charge credit to the PPFAC of 0.53 cents per kWh. As a result of the new PPFAC rate, in the first quarter of 2012, TEP moved the entire \$15 million of under-collected costs from Regulatory Assets - Noncurrent to Regulatory Assets - Current on the balance sheets.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited****UNS Gas Purchased Gas Adjustor**

In May 2012, the ACC approved a Purchased Gas Adjustor (PGA) temporary surcredit of 4.5 cents per therm for the period of May 2012 through April 2014. At September 30, 2012, the PGA bank balance was over-collected by \$17 million on a billed-to-customer basis, an increase of \$9 million from December 31, 2011. UNS Gas is required to request an additional surcredit if deferral balances reflect \$10 million or more on a billed-to-customer basis.

UNSE Purchased Power and Fuel Adjustment Clause

The UNSE annual PPFAC rate filing in April 2012 reflected lower forecasted purchased power and fuel expenses for the period of April 2012 through May 2013, resulting in the need for a surcredit to return anticipated over-recovered fuel and purchased power expense to ratepayers. In May 2012, the ACC approved a surcredit of 1.44 cents per kWh PPFAC rate, effective June 2012.

REGULATORY ASSETS AND LIABILITIES

The following table summarizes significant changes in regulatory assets and liabilities since December 31, 2011:

| | September 30, 2012 | | December 31, 2011 | |
|--|-----------------------|-----------------|-------------------|---------------|
| | TEP | UNS Energy | TEP | UNS Energy |
| | -Millions of Dollars- | | | |
| Regulatory Assets Current ⁽¹⁾ | \$ 41 | \$ 57 | \$ 72 | \$ 97 |
| Regulatory Assets Noncurrent ⁽²⁾ | 146 | 156 | 157 | 173 |
| Regulatory Liabilities Current | (24) | (48) | (24) | (42) |
| Regulatory Liabilities Noncurrent ⁽³⁾ | (234) | (271) | (201) | (235) |
| Total Net Regulatory Assets (Liabilities) | \$ (71) | \$ (106) | \$ 4 | \$ (7) |

(1) Regulatory Assets Current on the balance sheet is lower due to the change in TEP's PPFAC rate resulting in higher collection of deferred fuel and purchased power costs.

(2) Regulatory Assets Noncurrent on the balance sheet is lower primarily due the reclassification of TEP's PPFAC balance to Regulatory Assets Current and lower derivative balances related to non-trading gas swaps for TEP, UNS Gas and UNS Electric.

(3) Regulatory Liabilities Noncurrent on the balance sheet is higher due to the increase in net cost of removal for interim retirements as a result of generation asset retirements in 2012 at TEP.

RENEWABLE ENERGY STANDARD**TEP Renewable Energy Standard**

In July 2012, TEP filed its 2013 RES implementation plan. TEP's plan proposes to collect approximately \$41 million from customers during 2013. The plan includes a proposal to invest \$28 million in 2013 for company-owned solar projects, of which \$8 million was previously approved by the ACC, as well as the continuation of the funding mechanism for company-owned solar projects. TEP cannot predict if or when the ACC will approve its plan.

UNS Electric Renewable Energy Standard

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In July 2012, UNS Electric filed its 2013 RES implementation plan. UNS Electric's plan proposes to collect approximately \$9 million from customers during 2013, a portion of which is expected to provide recovery of operating costs and a return on investment to UNS Electric for company-owned solar projects. UNS Electric cannot predict if or when the ACC will approve its plan.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited

ELECTRIC ENERGY EFFICIENCY STANDARDS

In May 2012, TEP filed a modification to its proposed 2011-2012 Energy Efficiency Implementation Plan with the ACC. The proposal includes a request for a performance incentive for 2012 ranging from approximately \$3 million to \$4 million and the collection of the performance incentive over a period from October 1, 2012 to December 31, 2012. An administrative law judge issued a recommended opinion and order in August 2012. TEP is unable to predict when the ACC will issue a final order in this matter. TEP has not recorded any income related to the proposed performance incentive in 2012.

NOTE 3. BUSINESS SEGMENTS

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

(1) TEP, a regulated electric utility business, is our largest subsidiary;

(2) UNS Gas is a regulated gas distribution utility business; and

(3) UNS Electric is a regulated electric utility business.

Results for the UNS Energy and UES holding companies, Millennium, and UED are included in Other below.

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

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

| | Reportable Segments | | | | Reconciling Adjustments | UNS Energy Consolidated |
|--|---------------------|------------|-----------------|-------|----------------------------|-------------------------------|
| | TEP | UNS Gas | UNS Electric | Other | | |
| -Millions of Dollars- | | | | | | |
| Income Statement | | | | | | |
| Three Months Ended September 30, 2012: | | | | | | |
| Operating Revenues External | \$ 362 | \$ 16 | \$ 59 | \$ | \$ | \$ 437 |
| Operating Revenues Intersegment ⁽¹⁾ | 5 | 2 | | 5 | (12) | |
| Income (Loss) Before Income Taxes | 72 | (1) | 10 | 1 | | 82 |
| Net Income | 45 | | 6 | | | 51 |
| Three Months Ended September 30, 2011: | | | | | | |
| Operating Revenues External | \$ 366 | \$ 17 | \$ 68 | \$ | \$ | \$ 451 |
| Operating Revenues Intersegment ⁽¹⁾ | 4 | 1 | | 4 | (9) | |
| Income (Loss) Before Income Taxes | 88 | (1) | 11 | | | 98 |
| Net Income (Loss) | 54 | (1) | 7 | | | 60 |

| | Reportable Segments | | | | Reconciling Adjustments | UNS Energy Consolidated |
|--|---------------------|------------|-----------------|-------|----------------------------|-------------------------------|
| | TEP | UNS Gas | UNS Electric | Other | | |
| -Millions of Dollars- | | | | | | |
| Income Statement | | | | | | |
| Nine Months Ended September 30, 2012: | | | | | | |
| Operating Revenues External | \$ 877 | \$ 89 | \$ 157 | \$ | \$ | \$ 1,123 |
| Operating Revenues Intersegment ⁽¹⁾ | 13 | 4 | 1 | 14 | (32) | |
| Income Before Income Taxes | 104 | 8 | 23 | | | 135 |
| Net Income (Loss) | 65 | 5 | 14 | (1) | | 83 |
| Nine Months Ended September 30, 2011: | | | | | | |
| Operating Revenues External | \$ 894 | \$ 101 | \$ 169 | \$ 1 | \$ | \$ 1,165 |
| Operating Revenues Intersegment ⁽¹⁾ | 11 | 2 | 2 | 19 | (34) | |
| Income Before Income Taxes | 136 | 10 | 23 | | (4) | 165 |
| Net Income | 84 | 6 | 14 | | (2) | 102 |

(1) TEP includes in Operating Revenues External Intersegment: control area services provided to UNS Electric based on a FERC-approved tariff; common costs (systems, facilities, etc.) allocated to affiliates on a cost-causative basis; and sales of power to UNS Electric at Dow Jones Four Corners Daily Index prices.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited

NOTE 4. DEBT AND CREDIT FACILITIES

We summarize below the significant changes to our debt from those reported in our 2011 Annual Report on Form 10-K.

UNS ENERGY DEBT CONVERTIBLE SENIOR NOTES

In 2005, UNS Energy issued \$150 million of 4.50% Convertible Senior Notes (Convertible Senior Notes) due in 2035. UNS Energy converted or redeemed the entire \$150 million Convertible Senior Notes outstanding. Holders of the Convertible Senior Notes had the option of converting their interests to Common Stock at a conversion rate applicable at the time of each notice of redemption or receiving par plus accrued interest for the Convertible Senior Notes. In the first quarter of 2012, holders of approximately \$73 million of the Convertible Senior Notes converted their interests into approximately 2.1 million shares of Common Stock and \$2 million were redeemed for cash. In the second quarter of 2012, holders of approximately \$74 million of Convertible Senior Notes converted their interests into approximately 2.2 million shares of Common Stock and \$1 million were redeemed for cash.

UNS ENERGY CREDIT AGREEMENT

UNS Energy had \$63 million in outstanding borrowings at September 30, 2012, and \$57 million in outstanding borrowings at December 31, 2011, under its revolving credit facility. We have included the revolver borrowings in Long-Term Debt on the balance sheets as UNS Energy has the ability and the intent to have outstanding borrowings for the next twelve months. As of October 22, 2012, UNS Energy had \$31 million in outstanding borrowings under its revolving credit facility.

TEP UNSECURED NOTES

In September 2012, TEP issued \$150 million of 3.85% unsecured notes due March 2023. TEP may call the debt prior to December 15, 2022, with a make-whole premium plus accrued interest. After December 15, 2022, TEP may call the debt at par plus accrued interest. The unsecured notes contain a limitation on the amount of secured debt that TEP may have outstanding. TEP used the net proceeds to repay approximately \$72 million outstanding on the revolving credit facility, with the remaining proceeds to be used for general corporate purposes. TEP capitalized approximately \$1 million in costs related to the issuances of unsecured notes and will amortize the costs to Interest Expense Long-Term Debt through March 2023, the term of the unsecured notes.

TEP TAX-EXEMPT BONDS

In March 2012, the Industrial Development Authority of Apache County, Arizona issued \$177 million of unsecured tax-exempt pollution control bonds on behalf of TEP. The bonds bear interest at a fixed rate of 4.5%, mature in March 2030, and may be redeemed at par on or after March 1, 2022. The proceeds from the sale of the bonds, together with \$7 million of principal and \$1 million for accrued interest provided by TEP, were deposited with a trustee to retire \$184 million of unsecured tax-exempt bonds with interest rates of 5.85% and 5.875% and maturity dates ranging from 2026 to 2033. TEP's \$8 million payment to the trustee was the only cash flow activity since proceeds from the newly-issued bonds were not received or disbursed by TEP. TEP capitalized approximately \$2 million in costs related to the issuance of the bonds and will amortize the costs to Interest Expense Long-Term Debt through March 2030, the term of the bonds.

In June 2012, the Industrial Development Authority of Pima County, Arizona issued approximately \$16 million of unsecured tax-exempt industrial development bonds on behalf of TEP. The bonds bear interest at a fixed rate of 4.5%, mature in June 2030, and may be redeemed at par on or after June 1, 2022. The proceeds from the sale of the bonds together with \$0.4 million accrued interest provided by TEP, were deposited with a trustee to retire approximately \$16 million of outstanding unsecured tax-exempt bonds with interest rates of 5.85% and 5.875%, and maturity dates ranging from 2026 to 2033. TEP's payment of accrued interest was the only cash flow activity since proceeds from the newly-issued bonds were not received or disbursed by TEP. TEP capitalized less than \$0.5 million in costs related to the issuance of the bonds and will amortize the costs to Interest Expense Long-Term Debt through June 2030, the term of the bonds.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited

TEP CREDIT AGREEMENT

TEP had no borrowings outstanding and \$1 million in letters of credit (LOCs) issued under its revolving credit facility at September 30, 2012. At December 31, 2011, TEP had \$10 million in borrowings and \$1 million outstanding in LOCs under its revolving credit facility. TEP included the revolver borrowings in Current Liabilities on the balance sheets. Outstanding LOCs are not shown on the balance sheets. As of October 22, 2012, TEP had no borrowings and \$1 million outstanding in LOCs under its revolving credit facility.

UNS GAS/UNS ELECTRIC CREDIT AGREEMENT

UNS Electric had \$1 million at September 30, 2012, and \$6 million at December 31, 2011, in outstanding LOCs under the UNS Gas/UNS Electric Credit Agreement, which are not shown on the balance sheets. As of October 22, 2012, UNS Electric had \$1 million in outstanding LOCs under the UNS Gas/UNS Electric Credit Agreement.

COVENANT COMPLIANCE

As of September 30, 2012, UNS Energy and its subsidiaries were in compliance with the terms of their respective loan and credit agreements.

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The differences between Income Tax Expense and the amount obtained by multiplying pre-tax income by the United States statutory federal income tax rate of 35% are as follows:

| | Three Months Ended September 30, | | | |
|---|----------------------------------|--------------|--------------|--------------|
| | UNS Energy | | TEP | |
| | 2012 | 2011 | 2012 | 2011 |
| | -Millions of Dollars- | | | |
| Federal Income Tax Expense at Statutory Rate | \$ 29 | \$ 34 | \$ 25 | \$ 31 |
| State Income Tax Expense, Net of Federal Deduction | 3 | 5 | 3 | 4 |
| Federal/State Tax Credits | (1) | | (1) | |
| Allowance for Equity Funds Used During Construction | | (1) | | (1) |
| Total Federal and State Income Tax Expense | \$ 31 | \$ 38 | \$ 27 | \$ 34 |

| | Nine Months Ended September 30, | | | |
|---|---------------------------------|--------------|--------------|--------------|
| | UNS Energy | | TEP | |
| | 2012 | 2011 | 2012 | 2011 |
| | -Millions of Dollars- | | | |
| Federal Income Tax Expense at Statutory Rate | \$ 47 | \$ 58 | \$ 37 | \$ 48 |
| State Income Tax Expense, Net of Federal Deduction | 6 | 8 | 4 | 6 |
| Federal/State Tax Credits | (1) | (1) | (1) | (1) |
| Allowance for Equity Funds Used During Construction | (1) | (2) | (1) | (1) |
| Total Federal and State Income Tax Expense | \$ 51 | \$ 63 | \$ 39 | \$ 52 |

The Internal Revenue Service completed its audit of the 2008 tax return in March 2012 with no change to the financial statements, including no change to unrecognized tax benefits.

NOTE 6. COMMITMENTS, CONTINGENCIES, AND PROPOSED ENVIRONMENTAL MATTERS

In addition to those reported in our 2011 Annual Report on Form 10-K, we entered into the following new long-term commitments.

TEP COMMITMENTS

In February 2012, TEP entered into a long-term agreement for information technology services. TEP is obligated to pay \$2 million per year through December 2014.

TEP has a 20-year Power Purchase Agreement (PPA) with a renewable energy generation facility that achieved commercial operation in August 2012. TEP is obligated to purchase 100% of the output from this facility. TEP expects to make minimum payment obligations under this contract of approximately \$1 million per year in each of the next five years and thereafter, approximately \$7 million total in the remaining years.

UNS GAS COMMITMENTS

UNS Gas entered into new forward fuel commitments that settle through July 2015 at fixed prices per million British thermal units (MMBtu). UNS Gas minimum payment obligations for these purchases are \$2 million in 2013, \$4 million in 2014, and \$2 million in 2015.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited

UNS ELECTRIC COMMITMENTS

UNS Electric entered into new forward purchase power commitments that will settle through December 2014. Some of these contracts are at fixed prices per MWh and others are indexed to natural gas prices. Based on projected market prices as of September 30, 2012, UNS Electric's estimated minimum payment obligations for these purchases are \$2 million in 2013 and \$8 million in 2014.

TEP CONTINGENCIES

Springerville Generating Station Unit 3 Outage

In July 2012, Springerville Unit 3 experienced an unplanned outage. As a result of the outage, in July 2012, TEP recorded a pre-tax loss of \$2 million as TEP does not expect to meet certain availability requirements under the terms of TEP's operating agreement with Tri-State. The unit was operational again in October 2012.

Claim Related to San Juan Generating Station

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

Claims Related to Four Corners Generating Station

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

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

Mine Closure Reclamation at Generating Stations Not Operated by TEP

TEP pays ongoing reclamation costs related to coal mines that supply generating stations in which TEP has an ownership interest but does not operate. TEP is liable for a portion of final reclamation costs upon closure of the mines servicing Navajo Generating Station (Navajo), San Juan, and Four Corners. TEP's share of reclamation costs is expected to be \$27 million upon expiration of the coal supply agreements, which expire between 2016 and 2019. The reclamation liability (present value of future liability) recorded at September 30, 2012, was \$15 million and at December 31, 2011, was \$13 million.

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

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

In June 2012, the participants at San Juan executed a Trust Reclamation Agreement requiring each participant to individually establish and fund a trust based on the participant's share of the estimated final mine reclamation costs. The trust must remain in effect through completion of final mine reclamation activities currently projected to be 2050. TEP established and funded its trust with \$1 million in the third quarter of 2012. TEP anticipates making an additional deposit to the trust of \$0.3 million by the end of the year. TEP expects to make additional cumulative deposits to the trust of approximately \$1 million over the next five years.

Tucson to Nogales Transmission Line

TEP and UNS Electric are parties to a project development agreement for the joint construction of a 60-mile transmission line from Tucson, Arizona to Nogales, Arizona. UNS Electric's participation in this project was initiated in response to an order by the ACC to improve the reliability of electric service in Nogales. That order was issued before UNS Energy purchased the electric system in Nogales and surrounding Santa Cruz County in August 2003.

In 2002, the ACC authorized construction of the proposed 345-kV line along a route identified as the Western Corridor subject to a number of conditions, including the issuance of all required permits from state and federal agencies. The United States Forest Service subsequently expressed its preference for a different route in its final Environmental Impact Statement for the project. If a decision is made to pursue an alternative route, approvals would be needed from the ACC, the Department of Energy, the United States Forest Service, the Bureau of Land Management, and the International Boundary and Water Commission. As of September 30, 2012, and December 31, 2011, TEP had capitalized \$11 million related to the project, including \$2 million to secure land and land rights.

Based on the cost of the proposed 345-kV line, and difficulty in reaching agreement with the Forest Service on a path for the line, TEP proposed to abandon this project in its general rate case filed with the ACC in July 2012. TEP requested rate recovery of the \$9 million of non-land related costs over a three-year amortization period. TEP believes cost recovery is probable for the \$9 million of prudent and reasonably incurred costs related to the project as a consequence of the ACC's requirement for the 60-mile transmission line to the Nogales area.

Resolution of Contingencies

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 United States District Court for the District of New Mexico against Public Service Company of New Mexico (PNM), as operator of San Juan; PNM's parent PNM Resources, Inc. (PNMR); SJCC; and SJCC's parent BHP Minerals International Inc. (BHP). The Sierra Club alleged 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 constitutes 'open dumping' in violation of RCRA. The RCRA claims were asserted against PNM, PNMR, SJCC, and BHP. The suit also included claims under SMCRA which were directed only against SJCC and BHP. The suit sought 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. In March 2012, the parties settled the case. The settlement was approved by the court.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited

TEP is responsible for its share of the settlement of the San Juan claims. TEP recorded less than \$1 million for its share of the costs to fund environmental projects and Sierra Club attorney and expert fees required by the settlement, substantially all of which was recorded in 2011. In addition, TEP expects to pay \$1 million for its share of construction costs for a new groundwater recovery system adjacent to San Juan and other environmental projects required by the settlement.

San Juan Mine Fire

In September 2011, a fire at the underground mine that provides coal to San Juan caused mining operations to shut down. The mine resumed production in June 2012. The mine fire did not have a material effect on TEP's financial condition, results of operations, or cash flows due to the use of on-hand inventory of previously mined coal and the low market price of wholesale power during the closure.

PROPOSED ENVIRONMENTAL MATTERS

The Environmental Protection Agency (EPA) limits the amount of sulfur dioxide (SO₂), nitrogen oxide (NO_x), particulate matter, mercury and other emissions released into the atmosphere by power plants. TEP may incur added costs to comply with future changes in federal and state environmental laws, regulations, and permit requirements at its power plants. Complying with these changes may reduce operating efficiency. TEP expects to recover the cost of environmental compliance from its ratepayers.

Hazardous Air Pollutant Requirements

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

Navajo

Based on the EPA's final standards, Navajo may need mercury and particulate matter emission control equipment by 2015. TEP's share of the estimated capital cost of this equipment is less than \$1 million for mercury control and about \$43 million if the installation of baghouses to control particulates is necessary. TEP expects its share of the annual operating costs for mercury control and baghouses to be less than \$1 million each. The operator of Navajo is currently analyzing the need for baghouses under various regulatory scenarios, which will be affected by final Best Available Retrofit Technology (BART) rules when issued.

San Juan

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

Four Corners

Based on the EPA's final standards, Four Corners may need mercury emission control equipment by 2015. The estimated capital cost of this equipment is less than \$1 million. TEP expects the annual operating cost of the mercury emission control equipment to be less than \$1 million.

Springerville Generating Station

Based on the EPA's final standards, Springerville Generating Station (Springerville) may need mercury emission control equipment by 2015. The estimated capital cost of this equipment for Springerville Units 1 and 2 is about \$5 million. TEP expects the annual operating cost of the mercury emission control equipment to be about \$3 million.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited

Sundt Generating Station

TEP expects the final EPA standards will have little effect on capital expenditures at Sundt Generating Station.

Regional Haze Rules

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

Complying with the EPA's BART findings, and with other future environmental rules, may make it economically impractical to continue operating the Navajo, San Juan, and Four Corners power plants or for individual owners to continue to participate in these power plants. TEP cannot predict the ultimate outcome of these matters.

Navajo

TEP expects the EPA to issue a final rule establishing the BART for Navajo later in 2012. If the EPA decides that Selective Catalytic Reduction (SCR) technology is required at Navajo, TEP estimates its share of the capital cost will be \$42 million. Also, the installation of SCR technology at Navajo could increase the generating facility's particulate emissions which may require that baghouses be installed. TEP estimates that its share of the capital expenditure for baghouses would be about \$43 million. Until the EPA issues a final ruling, pollution control costs will not be known. If the EPA finalizes a BART rule for Navajo that requires SCR technology, TEP expects the owners to have five years to comply.

San Juan

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

In 2011, PNM filed a petition for review of and a motion to stay the FIP with the Tenth Circuit United States Court of Appeals (Circuit Court). In addition, PNM filed a request for reconsideration of the rule with the EPA and a request to stay the effectiveness of the rule pending the EPA's reconsideration and the review by the Circuit Court. The State of New Mexico filed similar motions with the Circuit Court and the EPA. In March 2012, the Circuit Court denied PNM's and the State of New Mexico's motion for stay. In July 2012, the EPA issued a 90-day stay to allow the State of New Mexico, the EPA, PNM, and other interested parties to evaluate alternatives to the final FIP.

In October 2012, the State of New Mexico released a proposed settlement agreement that it presented to the EPA as an alternative to the FIP. The proposed settlement includes: the retirement of San Juan Units 1 and 2 by December 31, 2017, and the replacement of those units with non-coal generation sources; and the installation of selective non-catalytic reduction technology on San Juan Units 3 and 4. Also in October 2012 the EPA extended the 90-day stay of the FIP for an additional 45 days to allow for further discussions on the proposed settlement agreement.

TEP owns 340 MW, or 50%, of San Juan Units 1 and 2. At September 30, 2012, the book value of TEP's share of San Juan Units 1 and 2 was \$216 million. If the units are retired early, we expect to request ACC approval to recover, over a reasonable time period, all costs associated with the early closure of those units. We are evaluating various replacement resources in the event San Juan Units 1 and 2 are retired early, including the possibility of exchanging part of TEP's ownership in San Juan Units 1 and 2 for a portion of San Juan Units 3 and/or 4. Any decision regarding early closure and replacement resources will require various actions by third parties as well as UNS Energy board and regulatory approvals.

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Several environmental groups were granted permission to join in opposition to PNM's petition to review in the Circuit Court. In addition, WildEarth Guardians filed a separate appeal against the EPA challenging the FIP's five-year implementation schedule. PNM was granted permission to join in opposition to that appeal. In April 2012, PNM, the State of New Mexico, and WildEarth Guardians individually filed briefs on the merits in their respective Circuit Court appeals. Oral argument on the appeal was heard in October 2012. If the FIP compliance date is not extended or the decision to close the facilities is not made by the end of 2012, TEP may begin making capital expenditures to install SCRs on San Juan Units 1 and 2 in the first quarter of 2013, to meet the FIP compliance deadline. TEP cannot predict the ultimate outcome of this matter.

Four Corners

In August 2012, the EPA finalized the regional haze FIP for Four Corners. The final FIP requires SCR technology to be installed on all five units by 2017. However, the FIP also includes an alternative plan that allows APS to close their wholly owned Units 1, 2, and 3 and install SCR technology on Units 4 and 5. This option allows the installation of SCR technology to be delayed until July 2018. In either case, TEP's estimated share of the capital costs to install SCR technology is about \$35 million.

Springerville

Regional haze regulations requiring emission control upgrades do not apply to Springerville currently and are not likely to impact Springerville operations until after 2018.

Sundt Generating Station

The EPA is required to issue a proposal regarding unaddressed state regional haze compliance issues in December 2012. The proposal may, among other things, include a determination regarding whether Sundt Unit 4 could be regulated under certain regional haze provisions.

NOTE 7. EMPLOYEE BENEFIT PLANS

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

| | Three Months Ended September 30, | | | |
|---|---|-------------|--|-------------|
| | Pension Benefits | | Other Postretirement Benefits | |
| | 2012 | 2011 | 2012 | 2011 |
| | -Millions of Dollars- | | | |
| Components of Net Periodic Benefit Plan Cost | | | | |
| Service Cost | \$ 2 | \$ 2 | \$ 1 | \$ 1 |
| Interest Cost | 4 | 4 | 1 | 1 |
| Expected Return on Plan Assets | (4) | (4) | | |
| Amortization of Net Loss | 2 | 2 | | |
| Net Periodic Benefit Plan Cost | \$ 4 | \$ 4 | \$ 2 | \$ 2 |

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

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| | Nine Months Ended September 30, | | | |
|---|---------------------------------|--------------|-------------------------------------|-------------|
| | Pension Benefits | | Other Postretirement Benefits | |
| | 2012 | 2011 | 2012 | 2011 |
| | -Millions of Dollars- | | | |
| Components of Net Periodic Benefit Plan Cost | | | | |
| Service Cost | \$ 8 | \$ 7 | \$ 2 | \$ 2 |
| Interest Cost | 12 | 12 | 2 | 3 |
| Expected Return on Plan Assets | (13) | (12) | | |
| Amortization of Prior Service Costs | | | | (1) |
| Amortization of Net Loss | 5 | 5 | | |
| Net Periodic Benefit Plan Cost | \$ 12 | \$ 12 | \$ 4 | \$ 4 |

The table above includes pension benefit plan costs of \$2 million in 2012 and \$1 million in 2011 for UNS Gas and UNS Electric. The table also includes other postretirement benefit plan costs of less than \$0.1 million for UNS Gas and UNS Electric in each period presented.

NOTE 8. SHARE-BASED COMPENSATION PLANS**RESTRICTED STOCK UNITS AND PERFORMANCE SHARES****Restricted Stock Units**

In May 2012, the UNS Energy Compensation Committee granted 15,303 restricted stock units to non-employee directors at a grant date fair value of \$35.94 per share. The restricted stock units vest in one year or immediately upon death, disability, or retirement. Compensation expense equal to the fair market value on the grant date is recognized over the vesting period. Fully vested but undistributed stock unit awards accrue dividend equivalent stock units based on the fair market value of common shares on the date the dividend is paid. In 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 March 2012, the UNS Energy Compensation Committee granted 80,140 performance share awards to upper management. Half of the performance share awards had a grant date fair value, based on a Monte Carlo simulation, of \$32.71 per share. Those awards will be paid out in Common Stock based on a comparison of UNS Energy's cumulative Total Shareholder Return to the Edison Electric Institute Index during the performance period of January 1, 2012 through December 31, 2014. The remaining half had a grant date fair value of \$36.40 per share and will be paid out in Common Stock based on cumulative net income for the three-year period ended December 31, 2014. The performance shares vest based on the achievement of these goals by the end of the performance period; any unearned awards are forfeited. Vested performance shares are eligible for dividend equivalents during the performance period.

SHARE-BASED COMPENSATION EXPENSE

UNS Energy and TEP recorded less than \$1 million of share-based compensation expense for the three months ended September 30, 2012 and September 30, 2011. For the nine months ended September 30, 2012 and September 30, 2011, UNS Energy and TEP recorded share-based compensation expense of \$2 million.

At September 30, 2012, the total unrecognized compensation cost related to non-vested share-based compensation was \$3 million, which will be recorded as compensation expense over the remaining vesting periods through December 2014. At September 30, 2012, 1 million shares were awarded but not yet issued, including target performance based shares, under the share-based compensation plans.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited****NOTE 9. FAIR VALUE MEASUREMENTS**

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

The following tables present, by level within the fair value hierarchy, UNS Energy's and TEP's assets and liabilities accounted for at fair value on a recurring basis. These assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. There were no transfers between Levels 1, 2, or 3 for either reporting period.

| | Level 1 | UNS Energy Level 2 Level 3 September 30, 2012 | | Total |
|--|--------------|--|---------------|--------------|
| -Millions of Dollars- | | | | |
| Assets | | | | |
| Cash Equivalents ⁽¹⁾ | \$ 99 | \$ | \$ | \$ 99 |
| Rabbi Trust Investments to Support the Deferred Compensation and Supplemental Executive Retirement Plans (SERP) ⁽²⁾ | | 18 | | 18 |
| Energy Contracts ⁽³⁾ | | 5 | 6 | 11 |
| Total Assets | 99 | 23 | 6 | 128 |
| Liabilities | | | | |
| Energy Contracts ⁽³⁾ | | (9) | (12) | (21) |
| Interest Rate Swaps ⁽⁴⁾ | | (11) | | (11) |
| Total Liabilities | | (20) | (12) | (32) |
| Net Total Assets and (Liabilities) | \$ 99 | \$ 3 | \$ (6) | \$ 96 |

| | Level 1 | UNS Energy Level 2 Level 3 December 31, 2011 | | Total |
|--|-----------|---|-----------|-----------|
| -Millions of Dollars- | | | | |
| Assets | | | | |
| Cash Equivalents ⁽¹⁾ | \$ 23 | \$ | \$ | \$ 23 |
| Rabbi Trust Investments to Support the Deferred Compensation and SERP ⁽²⁾ | | 16 | | 16 |
| Energy Contracts ⁽³⁾ | | | 14 | 14 |
| Total Assets | 23 | 16 | 14 | 53 |
| Liabilities | | | | |
| Energy Contracts ⁽³⁾ | | (21) | (24) | (45) |
| Interest Rate Swaps ⁽⁴⁾ | | (12) | | (12) |

| | | | | |
|---|-------|---------|---------|--------|
| Total Liabilities | (33) | (24) | (57) | |
| Net Total Assets and (Liabilities) | \$ 23 | \$ (17) | \$ (10) | \$ (4) |

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| | Level 1 | TEP | | Total |
|--|--------------|-----------------------|------------|--------------|
| | | Level 2 | Level 3 | |
| | | September 30, 2012 | | |
| | | -Millions of Dollars- | | |
| Assets | | | | |
| Cash Equivalents ⁽¹⁾ | \$ 77 | \$ | \$ | \$ 77 |
| Rabbi Trust Investments to Support the Deferred Compensation and SERP ⁽²⁾ | | 18 | | 18 |
| Energy Contracts ⁽³⁾ | | 3 | 2 | 5 |
| Total Assets | 77 | 21 | 2 | 100 |
| Liabilities | | | | |
| Energy Contracts ⁽³⁾ | | (4) | (2) | (6) |
| Interest Rate Swaps ⁽⁴⁾ | | (11) | | (11) |
| Total Liabilities | | (15) | (2) | (17) |
| Net Total Assets and (Liabilities) | \$ 77 | \$ 6 | \$ | \$ 83 |

| | Level 1 | TEP | | Total |
|--|-------------|-----------------------|------------|-------------|
| | | Level 2 | Level 3 | |
| | | December 31, 2011 | | |
| | | -Millions of Dollars- | | |
| Assets | | | | |
| Cash Equivalents ⁽¹⁾ | \$ 8 | \$ | \$ | \$ 8 |
| Rabbi Trust Investments to Support the Deferred Compensation and SERP ⁽²⁾ | | 16 | | 16 |
| Energy Contracts ⁽³⁾ | | | 3 | 3 |
| Total Assets | 8 | 16 | 3 | 27 |
| Liabilities | | | | |
| Energy Contracts ⁽³⁾ | | (9) | (3) | (12) |
| Interest Rate Swaps ⁽⁴⁾ | | (11) | | (11) |
| Total Liabilities | | (20) | (3) | (23) |
| Net Total Assets and (Liabilities) | \$ 8 | \$ (4) | \$ | \$ 4 |

- (1) Cash Equivalents are based on observable market prices and include the fair value of money market funds and certificates of deposit. These amounts are included in Cash and Cash Equivalents and in Investments and Other Property Other on the balance sheets.
- (2) Rabbi Trust Investments include 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 on the balance sheets.
- (3) Energy Contracts include gas swap agreements (Level 2), gas and power options (Level 3), forward power purchase and sales contracts (Level 3), and forward power purchase contracts indexed to gas (Level 3), entered into to reduce exposure to energy price risk. These contracts are included in Derivative Instruments and Other Assets on the balance sheets. The valuation techniques are described below. See Note 13.

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

ENERGY CONTRACTS

We primarily apply the market approach for recurring fair value measurements. When we have observable inputs for substantially the full term of the asset or liability, such as gas swap derivatives valued using New York Mercantile Exchange pricing, adjusted for basis differences, we categorize the instrument in Level 2. We categorize derivatives in Level 3 when we use an aggregate pricing service or published prices that represent a consensus reporting of multiple brokers.

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

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

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

We estimate the fair value of our options using a Black-Scholes-Merton option pricing model which includes inputs such as implied volatility, correlations, interest rates, and forward price curves.

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

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

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

| | Fair Value at September 30, 2012 | | Range of Unobservable Input |
|--|----------------------------------|----------------|--------------------------------|
| | Assets | Liabilities | |
| | -Millions of Dollars- | | |
| Forward Contracts⁽¹⁾ | \$ 4 | \$ (12) | |
| Valuation Technique: Market approach | | | |
| Unobservable Input: | | | |
| Market price per MWh | | | \$ 22.00 - \$ 55.93 |
| Option Contracts⁽²⁾ | 2 | | |
| Valuation Technique: Option model | | | |
| Unobservable Inputs: | | | |
| Market Price per MWh | | | \$ 30.00 - \$ 47.00 |
| Power Volatility | | | 29.26% - 55.50% |
| Market Price per MMBtu | | | \$ 2.87 - \$ 4.05 |
| Gas Volatility | | | 28.01% - 39.78% |
| Level 3 Energy Contracts | \$ 6 | \$ (12) | |

(1) TEP comprises \$2 million of the forward contract liabilities.

(2) All of the option contracts relate to TEP.

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

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

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

| | Three Months Ended September 30, 2012 | |
|--|--|------------|
| | UNS Energy | TEP |
| | -Millions of Dollars- | |
| Balance as of June 30, 2012 | \$ (7) | \$ (1) |
| Realized/Unrealized Gains/(Losses) Recorded to: | | |
| Net Regulatory Assets/Liabilities Derivative Instruments | | 1 |
| Settlements | 1 | |
| Balance as of September 30, 2012 | \$ (6) | \$ |
| Total Gains/(Losses) Attributable to the Change in Unrealized Gains/(Losses) Relating to Assets/Liabilities Still Held at the End of the Period | \$ | \$ |

| | Nine Months Ended September 30, 2012 | |
|--|---|------------|
| | UNS Energy | TEP |
| | -Millions of Dollars- | |
| Balance as of December 31, 2011 | \$ (10) | \$ |
| Realized/Unrealized Gains/(Losses) Recorded to: | | |
| Net Regulatory Assets/Liabilities Derivative Instruments | (4) | |
| Settlements | 8 | |
| Balance as of September 30, 2012 | \$ (6) | \$ |
| Total Gains/(Losses) Attributable to the Change in Unrealized Gains/(Losses) Relating to Assets/Liabilities Still Held at the End of the Period | \$ (1) | \$ |

| | Three Months Ended September 30, 2011 | |
|--|--|------------|
| | UNS Energy | TEP |
| | -Millions of Dollars- | |
| Balance as of June 30, 2011 | \$ (9) | \$ 1 |
| Realized/Unrealized Gains/(Losses) Recorded to: | | |
| Net Regulatory Assets/Liabilities Derivative Instruments | (3) | 1 |
| Settlements | 2 | (1) |

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| | | |
|--|---------|------|
| Balance as of September 30, 2011 | \$ (10) | \$ 1 |
| Total Gains/(Losses) Attributable to the Change in Unrealized Gains/(Losses) Relating to Assets/Liabilities Still Held at the End of the Period | \$ (3) | \$ 1 |

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

| | Nine Months Ended September 30, 2011 | |
|--|---|------------|
| | UNS Energy | TEP |
| | -Millions of Dollars- | |
| Balance as of December 31, 2010 | \$ (10) | \$ 1 |
| Realized/Unrealized Gains/(Losses) Recorded to: | | |
| Net Regulatory Assets/Liabilities Derivative Instruments | (6) | 2 |
| Other Comprehensive Income | (1) | (1) |
| Settlements | 7 | (1) |
| Balance as of September 30, 2011 | \$ (10) | \$ 1 |
| Total Gains/(Losses) Attributable to the Change in Unrealized Gains/(Losses) Relating to Assets/Liabilities Still Held at the End of the Period | \$ (6) | \$ 1 |

FINANCIAL INSTRUMENTS NOT CARRIED AT FAIR VALUE

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

The carrying amounts of our current assets, current liabilities, including current maturities of long-term debt, and amounts outstanding under our credit agreements approximate the fair values due to the short-term nature of these financial instruments. These items have been excluded from the table below.

For Investment in Lease Debt, we calculate the present value of remaining cash flows using current market rates for instruments with similar characteristics such as credit rating and time-to-maturity. We also incorporate the impact of counterparty credit risk using market credit default swap data.

For Investment in Lease Equity, we estimate the price at which an investor would realize a target internal rate of return. Our estimates include: the mix of debt and equity an investor would use to finance the purchase; the cost of debt; the required return on equity; and income tax rates. The estimate assumes a residual value based on an appraisal of Springerville Unit 1 in 2011.

For Long-Term Debt, we use quoted market prices, when available, or calculate the present value of remaining cash flows at the balance sheet date. When calculating present value, we use current market rates for bonds with similar characteristics such as credit rating and time-to-maturity. We consider the principal amounts of variable rate debt outstanding to be reasonable estimates of the fair value. We also incorporate the impact of our own credit risk using a credit default swap rate.

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

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

| | Fair Value Hierarchy | September 30, 2012 | | December 31, 2011 | |
|--------------------------------|----------------------|--------------------|------------|-------------------|------------|
| | | Carrying Value | Fair Value | Carrying Value | Fair Value |
| -Millions of Dollars- | | | | | |
| Assets: | | | | | |
| TEP Investment in Lease Debt | Level 2 | \$ 9 | \$ 9 | \$ 29 | \$ 29 |
| TEP Investment in Lease Equity | Level 3 | 36 | 22 | 37 | 21 |
| Liabilities: | | | | | |
| Long-Term Debt | | | | | |
| UNS Energy | Level 2 | 1,516 | 1,600 | 1,517 | 1,543 |
| TEP | Level 2 | 1,223 | 1,268 | 1,080 | 1,061 |

TEP intends to hold the Investment in Lease Debt to maturity. This investment is stated at amortized cost, which means the purchase cost has been adjusted for the amortization of the premium and discount to maturity.

The fair value of TEP's Long-Term Debt increased from prior period because of a change in valuation methodology concerning the make-whole premium applied to the bonds if they are called early.

NOTE 10. UNS ENERGY EARNINGS PER SHARE

We compute basic Earnings Per Share (EPS) by dividing Net Income by the weighted average number of common shares outstanding during the period. 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 Senior Notes. The numerator in calculating diluted EPS is Net Income adjusted for the interest on Convertible Senior Notes (net of tax) that would not be paid if the remaining notes, not yet converted, were converted to Common Stock.

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

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|--------------------|--------------------|--------------------|
| | September 30, 2012 | September 30, 2011 | September 30, 2012 | September 30, 2011 |
| -Thousands of Dollars- | | | | |
| Numerator: | | | | |
| Net Income | \$ 50,664 | \$ 59,712 | \$ 83,414 | \$ 101,787 |
| Income from Assumed Conversion of Convertible Senior Notes | | 1,097 | 1,100 | 3,292 |
| Adjusted Numerator | \$ 50,664 | \$ 60,809 | \$ 84,514 | \$ 105,079 |
| -Thousands of Shares- | | | | |
| Denominator: | | | | |
| Weighted Average Shares of Common Stock Outstanding: | | | | |
| Common Shares Issued | 41,290 | 36,867 | 39,835 | 36,739 |
| Fully Vested Deferred Stock Units | 156 | 136 | 148 | 127 |
| Participating Securities | | 50 | | 64 |

| | | | | | |
|---|----------------|--------|--------|--------|--------|
| Total Weighted Average Shares of Common Stock Outstanding and Participating Securities | Basic | 41,446 | 37,053 | 39,983 | 36,930 |
| Effect of Dilutive Securities: | | | | | |
| Convertible Senior Notes | | | 4,295 | 1,417 | 4,268 |
| Options and Stock Issuable Under Share-Based Compensation Plans | | 417 | 429 | 319 | 379 |
| Total Shares | Diluted | 41,863 | 41,777 | 41,719 | 41,577 |

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

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

| | Three Months | | Nine Months | |
|---|-----------------------|-------------|----------------------|-------------|
| | Ended | | Ended | |
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| | -Thousands of Shares- | | | |
| Stock Options Excluded from the Diluted EPS Computation | 147 | 67 | 158 | |

In the first half of 2012, the entire balance of Convertible Senior Notes was converted to Common Shares or redeemed for cash. See Note 4.

NOTE 11. MILLENNIUM INVESTMENTS

In 2009, Millennium sold an equity investment and recorded a \$6 million gain on the sale. Millennium received an upfront payment of \$5 million in 2009 and a \$15 million, three-year, 6% secured promissory note with a maturity date of June 2012. In June 2012, at the request of the borrower, Millennium agreed to change the payment provisions and maturity date of the note. The remaining terms of the note, including provisions securing the payment of the loan amount, remained unchanged. Under the modified payment terms, Millennium received the principal amount of \$15 million in monthly payments between June 2012 and October 2012, as well as a \$0.25 million amendment fee in June 2012. The note, including accrued interest, was fully repaid in October 2012.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited****NOTE 12. SUPPLEMENTAL CASH FLOW INFORMATION**

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

| | UNS Energy | |
|---|--------------------------|-------------------|
| | Nine Months Ended | |
| | September 30, | |
| | 2012 | 2011 |
| | -Thousands of Dollars- | |
| Net Income | \$ 83,414 | \$ 101,787 |
| Adjustments to Reconcile Net Income | | |
| To Net Cash Flows from Operating Activities | | |
| Depreciation Expense | 105,319 | 99,653 |
| Amortization Expense | 26,845 | 22,513 |
| Depreciation and Amortization Recorded to Fuel and Operations and Maintenance Expense | 4,911 | 4,513 |
| Amortization of Deferred Debt-Related Costs Included in Interest Expense | 2,250 | 3,185 |
| Provision for Retail Customer Bad Debts | 2,017 | 1,305 |
| Use of Renewable Energy Credits (REC) for Compliance | 4,017 | 4,669 |
| Deferred Income Taxes | 63,057 | 77,668 |
| Pension and Postretirement Expense | 16,391 | 15,903 |
| Pension and Postretirement Funding | (23,649) | (25,998) |
| Share-Based Compensation Expense | 1,952 | 2,025 |
| Allowance for Equity Funds Used During Construction | (2,708) | (3,516) |
| Increase (Decrease) to Reflect PPFAC/PGA Recovery | 29,730 | (5,174) |
| Competition Transition Charge Revenue Refunded | | (30,652) |
| Liquidated Damages for Springerville Unit 3 Outage | 1,921 | |
| Gain on Settlement of El Paso Electric Dispute | | (7,391) |
| Changes in Assets and Liabilities which Provided (Used) | | |
| Cash Exclusive of Changes Shown Separately | | |
| Accounts Receivable | (28,686) | (22,495) |
| Materials and Fuel Inventory | (33,038) | (195) |
| Accounts Payable | (5,220) | 9,507 |
| Income Taxes | (11,738) | (11,870) |
| Interest Accrued | (1,551) | (3,063) |
| Taxes Other Than Income Taxes | 16,478 | 17,048 |
| Other | 16,426 | 11,065 |
| Net Cash Flows Operating Activities | \$ 268,138 | \$ 260,487 |

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

| | TEP | |
|--|--------------------------|-------------------|
| | Nine Months Ended | |
| | September 30, | |
| | 2012 | 2011 |
| | -Thousands of Dollars- | |
| Net Income | \$ 65,018 | \$ 83,773 |
| Adjustments to Reconcile Net Income | | |
| To Net Cash Flows from Operating Activities | | |
| Depreciation Expense | 82,656 | 78,124 |
| Amortization Expense | 29,621 | 25,282 |
| Depreciation and Amortization Recorded to Fuel and Operations and Maintenance Expense | 3,922 | 3,280 |
| Amortization of Deferred Debt-Related Costs Included in Interest Expense | 1,628 | 1,866 |
| Provision for Retail Customer Bad Debts | 1,348 | 942 |
| Use of RECs for Compliance | 3,324 | 4,280 |
| Deferred Income Taxes | 51,638 | 66,090 |
| Pension and Postretirement Expense | 14,466 | 14,113 |
| Pension and Postretirement Funding | (20,989) | (23,453) |
| Share-Based Compensation Expense | 1,540 | 1,580 |
| Allowance for Equity Funds Used During Construction | (2,265) | (2,980) |
| Increase (Decrease) to Reflect PPFAC Recovery | 25,150 | (5,146) |
| Competition Transition Charge Revenue Refunded | | (30,652) |
| Liquidated Damages for Springerville Unit 3 Outage | 1,921 | |
| Gain on Settlement of El Paso Electric Dispute | | (7,391) |
| Changes in Assets and Liabilities which Provided (Used) Cash Exclusive of Changes Shown Separately | | |
| Accounts Receivable | (44,269) | (35,481) |
| Materials and Fuel Inventory | (32,448) | 144 |
| Accounts Payable | 4,977 | 16,030 |
| Income Taxes | (11,424) | (13,792) |
| Interest Accrued | 2,729 | 1,685 |
| Taxes Other Than Income Taxes | 16,710 | 16,541 |
| Other | 11,898 | 10,709 |
| Net Cash Flows Operating Activities | \$ 207,151 | \$ 205,544 |

Non-Cash Transactions

During the first nine months of 2012 the following non-cash transactions occurred:

In September 2012, TEP declared a \$30 million dividend to UNS Energy which was paid in October 2012;

UNS Energy converted \$147 million of the previously outstanding \$150 million Convertible Senior Notes into Common Shares. See Note 4; and

TEP redeemed \$193 million of the \$200 million tax-exempt bonds and reissued debt using a trustee. Since the cash flowed through trust accounts the redemption and reissuance of debt resulted in a non-cash transaction at TEP. See Note 4.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued) Unaudited****NOTE 13. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES****RISKS AND OVERVIEW**

We are exposed to energy price risk associated with our gas and purchased power requirements, volumetric risk associated with our seasonal load, and operational risk associated with our generating facilities, transmission, and transportation systems. We reduce our energy price risk through a variety of derivative and non-derivative instruments. The objectives for entering into such contracts include: creating price stability; meeting load and reserve requirements; and reducing exposure to price volatility that may result from delayed recovery under the PPFAC or PGA. See Notes 2 and 9.

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

DERIVATIVES POLICY

There have been no significant changes to our derivative instrument or credit risk policies as described in our Annual Report on Form 10-K for the year ended December 31, 2011.

FINANCIAL IMPACT OF DERIVATIVES**Cash Flow Hedges**

UNS Energy and TEP had liabilities related to cash flow hedges of \$13 million as of September 30, 2012 and \$14 million as of December 31, 2011. The after-tax unrealized gains and losses on derivative activities and amounts reclassified to earnings are reported in the statements of other comprehensive income.

Regulatory Treatment of Commodity Derivatives

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

| | UNS Energy | | TEP | |
|--|----------------------------------|------|--------|--------|
| | Three Months Ended September 30, | | | |
| | 2012 | 2011 | 2012 | 2011 |
| | -Millions of Dollars- | | | |
| Increase (Decrease) to Regulatory Assets/Liabilities | \$ (12) | \$ 2 | \$ (6) | \$ (1) |

| | UNS Energy | | TEP | |
|---|---------------------------------|--------|--------|--------|
| | Nine Months Ended September 30, | | | |
| | 2012 | 2011 | 2012 | 2011 |
| | -Millions of Dollars- | | | |
| Decrease to Regulatory Assets/Liabilities | \$ (20) | \$ (7) | \$ (7) | \$ (3) |

The fair values of derivative assets and liabilities were as follows:

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| | UNS Energy | | TEP | |
|---------------------------------|-----------------------|----------------------|-----------------------|----------------------|
| | September 30, 2012 | December 31, 2011 | September 30, 2012 | December 31, 2011 |
| | -Millions of Dollars- | | | |
| Assets | \$ 10 | \$ 14 | \$ 5 | \$ 3 |
| Liabilities | (19) | (43) | (4) | (9) |
| Net Assets (Liabilities) | \$ (9) | \$ (29) | \$ 1 | \$ (6) |

Derivative assets are included in Other Current Assets and Other Non-Current Assets on the TEP balance sheet and Derivative Instruments and Other Non-Current Assets on the UNS balance sheet.

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

The realized losses on settled gas swaps that are fully recoverable through the PPFAC or PGA were as follows:

| | UNS Energy | | TEP | |
|--------------------------------------|----------------------------------|--------|--------|--------|
| | Three Months Ended September 30, | | | |
| | 2012 | 2011 | 2012 | 2011 |
| | -Millions of Dollars- | | | |
| Realized Losses on Settled Gas Swaps | \$ (7) | \$ (6) | \$ (4) | \$ (4) |

| | UNS Energy | | TEP | |
|--------------------------------------|---------------------------------|---------|---------|--------|
| | Nine Months Ended September 30, | | | |
| | 2012 | 2011 | 2012 | 2011 |
| | -Millions of Dollars- | | | |
| Realized Losses on Settled Gas Swaps | \$ (20) | \$ (15) | \$ (10) | \$ (6) |

At September 30, 2012, UNS Energy and TEP had contracts that will settle through the third quarter of 2015.

Other Commodity Derivatives

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

| | Three Months | | Nine Months | |
|---|-----------------------|--------|---------------|--------|
| | Ended | | | |
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| | -Millions of Dollars- | | | |
| Recorded in Wholesale Sales: | | | | |
| Forward Power Sales | \$ 1 | \$ 6 | \$ 2 | \$ 9 |
| Forward Power Purchases | (1) | (8) | (3) | (12) |
| Total Sales and Purchases Not Resulting in Physical Delivery | \$ | \$ (2) | \$ (1) | \$ (3) |

DERIVATIVE VOLUMES

At September 30, 2012, UNS Energy had gas swaps totaling 19,116 billion British thermal units (GBtu) and power contracts totaling 2,018 gigawatt-hours (GWh), while TEP had gas swaps totaling 10,884 GBtu and power contracts totaling 666 GWh. At December 31, 2011, UNS Energy had gas swaps totaling 14,856 GBtu and power contracts totaling 3,147 GWh, while TEP had gas swaps totaling 6,855 GBtu and power contracts totaling 815 GWh. We account for gas swaps and power contracts 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 also consider the impact of our own credit risk on instruments that are in a net liability position. The impact of counterparty credit risk and our own credit risk on the fair value of derivative asset contracts was less than \$0.5 million at September 30, 2012 and at December 31, 2011.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Concluded) Unaudited****CONCENTRATION OF CREDIT RISK**

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, 2012. Since credit risk-related contingent features were not triggered in the periods presented, UNS Energy and TEP did not post cash collateral.

| | UNS Energy | TEP |
|--|-----------------------|-------|
| | September 30, 2012 | |
| | -Millions of Dollars- | |
| Net Liability Position | \$ 38 | \$ 16 |
| Letters of Credit | 2 | 1 |
| Additional Collateral to Post if Contingent Features Triggered | 38 | 16 |

As of September 30, 2012, TEP had \$14 million of credit exposure to other counterparties creditworthiness related to its wholesale marketing and gas hedging activities, of which three counterparties individually composed greater than 10% of the total credit exposure. UNS Electric had less than \$1 million of such credit exposure related to its supply and hedging contracts. At September 30, 2012, UNS Gas had no exposure to other counterparties creditworthiness.

NOTE 14. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board issued authoritative guidance which amends the guidance for impairment testing of indefinite-lived intangible assets. An entity will have the option to perform qualitative analysis to determine whether an indefinite-lived intangible asset may be impaired. If the qualitative assessment does not result in likely impairment, an entity will not be required to perform the quantitative impairment test. We will be required to comply in the first quarter of 2013; however we do not expect this pronouncement to have a material impact on our financial statements as our indefinite-lived intangible assets, RECs, are currently recoverable under the RES as we use the RECs to comply with the standard s renewable resources requirements.

NOTE 15. REVIEW BY INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The UNS Energy and TEP condensed consolidated financial statements as of September 30, 2012, and for the three and nine month periods ended September 30, 2012 and 2011, have been reviewed by PricewaterhouseCoopers LLP, an independent registered public accounting firm. Their reports (dated November 2, 2012) 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 for their reports on the unaudited financial information because neither of those reports is a report or a part of the registration statements prepared or certified by PricewaterhouseCoopers LLP within the meaning of Sections 7 and 11 of the Securities Act of 1933.

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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 UNS Energy Corporation (UNS Energy), formerly known as UniSource Energy Corporation, and its three primary business segments. It includes the following:

outlook and strategies;

operating results during the third quarter and nine-month period ended September 30, 2012, compared with the same periods in 2011;

factors affecting 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 (i) UNS Energy's and Tucson Electric Power Company's (TEP) 2011 Annual Report on Form 10-K and (ii) the Condensed Consolidated Financial Statements that begin on page three of this document. The Condensed Consolidated Financial Statements present the results of operations for the three and nine-month periods ended September 30, 2012 and 2011. Management's Discussion and Analysis explains the differences between periods for specific line items of the Condensed Consolidated Financial Statements.

UNS ENERGY CONSOLIDATED

OVERVIEW OF CONSOLIDATED BUSINESS

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

TEP is a regulated public utility and UNS Energy's largest operating subsidiary, representing approximately 84% of UNS Energy's total assets as of September 30, 2012. TEP generates, transmits, and distributes electricity to approximately 406,000 retail electric customers in a 1,155 square mile area in southeastern Arizona. TEP also sells electricity to other utilities and power marketing entities, located primarily in the western United States. In addition, TEP operates Springerville Generating Station (Springerville) Unit 3 on behalf of Tri-State Generation and Transmission Association, Inc. (Tri-State) and Springerville Unit 4 on behalf of Salt River Project Agricultural Improvement and Power District (SRP).

UES holds the common stock of two regulated public utilities, UNS Gas, Inc. (UNS Gas) and UNS Electric, Inc. (UNS Electric). UNS Gas is a regulated gas distribution company, which services approximately 147,000 retail customers in Mohave, Yavapai, Coconino, and Navajo counties in northern Arizona, as well as in Santa Cruz County in southern Arizona. UNS Electric is a regulated public utility, which generates, transmits, and distributes electricity to approximately 92,000 retail customers in Mohave and Santa Cruz counties. In July 2011, UNS Electric purchased the Black Mountain Generating Station (BMGS) from UED. This transaction did not impact UNS Energy's consolidated financial statements.

UED currently has no significant assets.

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Millennium's investments in unregulated businesses represent less than 1% of UNS Energy's assets as of September 30, 2012.

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

Table of Contents**OUTLOOK AND STRATEGIES**

Our financial prospects and outlook are affected by many factors including: the 2008 TEP Rate Order that freezes Base Rates through 2012; national and regional economic conditions; volatility in the financial markets; environmental laws and regulations; and other regulatory factors. Our plans and strategies include the following:

Obtain Arizona Corporation Commission (ACC) approval of a retail Base Rate increase and new retail rate design for TEP, effective no later than August 1, 2013, that: (i) provides adequate revenues to cover the rising cost of serving TEP's customers; (ii) aligns TEP's retail rates with Arizona's requirements for energy efficiency and renewable generation; and (iii) allows TEP an opportunity to earn a fair return on its investment.

Focus on our core utility businesses through operational excellence, investing in utility rate base, emphasizing customer satisfaction, maintaining a strong community presence, and achieving constructive regulatory outcomes.

Develop strategic responses to new environmental regulations and potential new legislation, including potential limits on Greenhouse Gas (GHG) 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.

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

RESULTS OF OPERATIONS**Contribution by Business Segment**

The table below shows the contributions to our consolidated after-tax earnings by business segment:

| | Three Months Ended | | Nine Months Ended | |
|--|-----------------------|--------------|-------------------|---------------|
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| | -Millions of Dollars- | | | |
| TEP | \$ 45 | \$ 54 | \$ 65 | \$ 84 |
| UNS Gas | | (1) | 5 | 6 |
| UNS Electric | 6 | 7 | 14 | 14 |
| Other Non-Reportable Segments and Adjustments ⁽¹⁾ | | | (1) | (2) |
| Consolidated Net Income | \$ 51 | \$ 60 | \$ 83 | \$ 102 |

⁽¹⁾ Includes: UNS Energy parent company expenses; Millennium; UED; and intercompany eliminations.

Executive Overview**Third Quarter of 2012 Compared with the Third Quarter of 2011**

TEP

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TEP reported net income of \$45 million in the third quarter of 2012 compared with net income of \$54 million in the third quarter of 2011. The decrease in net income in the third quarter of 2012 is attributable to: an \$8 million decrease in retail margin revenues; a \$2 million increase in depreciation and amortization expense; and a \$2 million decrease in pre-tax income related to the operation of Springerville Units 3 and 4; partially offset by a \$2 million decrease in Base Operations and Maintenance (Base O&M) expense. Third quarter 2011 results include a pre-tax gain of \$7 million related to the settlement of a dispute with El Paso Electric. See *Tucson Electric Power Company, Results of Operations*, below for more information.

Table of Contents*UNS Gas*

See *UNS Gas, Results of Operations*, below.

UNS Electric

See *UNS Electric, Results of Operations*, below.

Other Non-Reportable Segments

The results reported for Other Non-Reportable Segments include UNS Energy parent company expenses, Millennium, UED, and intercompany eliminations. See *Other Non-Reportable Segments, Results of Operations*, below, for more information.

Nine Months Ended September 30, 2012 Compared with the Nine Months Ended September 30, 2011*TEP*

TEP reported net income of \$65 million in the first nine months of 2012 compared with net income of \$84 million in the same period last year. The decrease in net income is attributable to: a \$4 million decrease in retail margin revenues; a \$9 million decrease in long-term wholesale margin revenues; a \$9 million increase in depreciation and amortization expense; and a \$3 million decrease in pre-tax income related to the operation of Springerville Unit 3. Results for the first nine months of 2011 include a pre-tax gain of \$7 million related to the settlement of a dispute with El Paso Electric. See *Tucson Electric Power Company, Results of Operations*, below for more information.

UNS Gas

See *UNS Gas, Results of Operations*, below.

UNS Electric

See *UNS Electric, Results of Operations*, below.

Operations and Maintenance Expense

The table below summarizes the items included in UNS Energy's Operations and Maintenance (O&M) expense:

| Three Months Ended September 30, | 2012 | 2011 |
|---|-----------------------|-------------|
| | -Millions of Dollars- | |
| UNS Energy Base O&M (Non-GAAP) ⁽¹⁾ | \$ 61 | \$ 63 |
| Reimbursed Expenses Related to Springerville Units 3 and 4 | 26 | 16 |
| Expenses Related to Customer-Funded Renewable Energy and Demand Side Management (DSM) Programs ⁽²⁾ | 11 | 12 |
| Total UNS Energy O&M (GAAP) | \$ 98 | \$ 91 |
| Nine Months Ended September 30, | | |
| UNS Energy Base O&M (Non-GAAP) ⁽¹⁾ | \$ 198 | \$ 199 |
| Reimbursed Expenses Related to Springerville Units 3 and 4 | 53 | 49 |
| Expenses Related to Customer-Funded Renewable Energy and DSM Programs ⁽²⁾ | 33 | 34 |
| Total UNS Energy O&M (GAAP) | \$ 284 | \$ 282 |

- (1) Base O&M, a non-GAAP financial measure, should not be considered as an alternative to O&M, which is determined in accordance with generally accepted accounting principles (GAAP) in the United States of America. We believe Base O&M provides useful information to investors because it represents the fundamental level of operating and maintenance expense related to our core business. Base O&M excludes expenses that are directly offset by revenues collected from customers and other third parties.
- (2) Represents expenses related to customer-funded renewable energy and DSM programs; these expenses are being collected from customers and the corresponding amounts are recorded in retail revenue.

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

Dividends from UNS Energy's subsidiaries represent the parent company's main source of liquidity. Under UNS Energy's tax sharing agreement, subsidiaries make income tax payments to UNS Energy, which makes payments on behalf of the consolidated group to taxing authorities. See *Income Tax Position*, below, for more information.

The table below provides a summary of the liquidity position of UNS Energy and each of its segments:

| Balances as of October 22, 2012 | Cash and Cash Equivalents | Borrowings under Revolving Credit Facility ⁽¹⁾ | Amount Available under Revolving Credit Facility |
|---------------------------------|---------------------------------|--|--|
| | | -Millions of Dollars- | |
| UNS Energy Stand-Alone | \$ 2 | \$ 31 | \$ 94 |
| TEP | 104 | 1 | 199 |
| UNS Gas | 32 | | 70 ⁽²⁾ |
| UNS Electric | 18 | 1 | 69 ⁽²⁾ |
| Other | 4 ⁽³⁾ | N/A | N/A |
| Total | \$ 160 | | |

⁽¹⁾ Includes Letters of Credit (LOCs) issued under revolving credit facilities.

⁽²⁾ Either UNS Gas or UNS Electric may borrow up to a maximum of \$70 million; the total combined amount borrowed by both companies cannot exceed \$100 million.

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

Dividends from Subsidiaries

In the third quarter of 2012, UNS Energy received \$14 million in dividends from Millennium, a \$10 million dividend from UNS Gas, and a \$10 million dividend from UNS Electric. In October 2012, UNS Energy received a \$30 million dividend from TEP. UNS Energy did not receive dividends from its subsidiaries during the third quarter of 2011.

Short-term Investments

UNS Energy's short-term investment policy governs the investment of excess cash balances. We regularly review and update this policy in response to market conditions. As of September 30, 2012, UNS Energy's short-term investments included highly-rated and liquid money market funds and certificates of deposit.

Access to Revolving Credit Facilities

We have access to working capital through revolving credit agreements with lenders. Each of these agreements is a committed facility that expires in November 2016. The TEP Credit Agreement and UNS Gas/UNS Electric Revolver may be used for revolving borrowings as well as to issue LOCs. TEP, UNS Gas, and UNS Electric each issue LOCs from time to time to provide credit enhancement to counterparties for their energy procurement and hedging activities. The UNS Credit Agreement also may be used to issue LOCs for general corporate purposes.

We believe that we have sufficient liquidity under our revolving credit facilities to meet short-term working capital needs and to provide credit enhancement as necessary under energy procurement and hedging agreements. See *Item 3. Quantitative and Qualitative Disclosures about Market Risk*, below.

Table of Contents**UNS Energy Consolidated Cash Flows**

| Nine Months Ended September 30, | 2012 | 2011 |
|--|-----------------------|-------------|
| | -Millions of Dollars- | |
| Operating Activities | \$ 268 | \$ 260 |
| Investing Activities | (192) | (216) |
| Financing Activities | (3) | (52) |

UNS Energy's operating cash flows are generated primarily by retail and wholesale energy sales at TEP, UNS Gas, and UNS Electric, net of the related payments for fuel and purchased power. Generally, cash from operations is lowest in the first quarter and highest in the third quarter due to TEP's summer-peaking load. TEP, UNS Gas, and UNS Electric typically use their revolving credit facilities to assist in funding their business activities during periods when sales are seasonally lower.

Capital expenditures at TEP, UNS Gas, and UNS Electric represent the primary use of cash for investing activities.

Cash used for investing and financing activities can fluctuate year-to-year depending on: capital expenditures; repayments and borrowings under revolving credit facilities; debt issuances or retirements; capital lease payments by TEP; and dividends paid by UNS Energy to its shareholders.

Operating Activities

In the first nine months of 2012, net cash flows from operating activities were \$8 million higher than they were in the same period last year due to:

a \$15 million decrease in payments of operations and maintenance costs and wages paid, net of amounts capitalized, due in part to lower renewable incentive payments, lower payments related to the operation of Springerville Units 3 and 4 from TEP, and lower pension contribution payments;

a \$3 million decrease in interest paid, net of amounts capitalized, due primarily to the redemption of UNS Energy Convertible Senior Notes (Convertible Senior Notes) in the first six months of 2012; and

a \$4 million decrease in capital lease interest paid due to lower capital lease obligation balances; partially offset by

a \$4 million decrease in income tax refunds received due to overestimated payments made in 2010 refunded in 2011;

a \$3 million decrease in interest received due to lower balances in investments in lease debt; and

a \$5 million increase in taxes other than income taxes paid due to higher property tax payments.

Investing Activities

Net cash flows used for investing activities decreased by \$24 million in the first nine months of 2012 compared with the same period last year. A \$31 million decrease in capital expenditures and the receipt of \$13 million related to a note receivable held by Millennium were offset by a \$19 million decrease in proceeds from investments in Springerville lease debt compared with the first nine months of 2011.

Capital Expenditures

| | Actual Year-to-Date September 30, 2012 | Estimate Full Year 2012 |
|-------------------------|---|--|
| | -Millions of Dollars- | |
| TEP | \$ 196 | \$ 287 |
| UNS Gas | 12 | 14 |
| UNS Electric | 24 | 40 |
| UNS Energy Consolidated | \$ 232 | \$ 341 |

Table of Contents**Financing Activities**

Net cash flows from financing activities were \$49 million higher in the first nine months of 2012 compared with the same period last year due primarily to an increase in proceeds from long-term debt, which was partially offset by an increase in capital lease payments and an increase in dividends paid on common stock.

UNS Credit Agreement

The UNS Credit Agreement, which expires in November 2016, consists of a \$125 million revolving credit and LOC facility. As of September 30, 2012, there was \$63 million outstanding at a weighted-average interest rate of 2.93%. The UNS Credit Agreement restricts additional indebtedness, liens, mergers, and sales of assets. The UNS Credit Agreement also requires UNS Energy to meet a minimum cash flow to interest coverage ratio determined on a UNS Energy stand-alone basis. Additionally, UNS Energy cannot exceed a maximum leverage ratio determined on a consolidated basis. Under the terms of the UNS Credit Agreement, UNS Energy may pay dividends so long as it maintains compliance with the agreement. UNS Energy's obligations under the agreement are secured by a pledge of the common stock of Millennium, UES, and UED.

As of September 30, 2012, we were in compliance with the terms of the UNS Credit Agreement.

Convertible Senior Notes

In March 2005, UNS Energy issued \$150 million of 4.50% Convertible Senior Notes due in 2035. Between December 2011 and May 2012, UNS Energy issued a series of separate notices of partial redemption of the Convertible Senior Notes by calling all \$150 million outstanding. Holders of the called Convertible Senior Notes had the option of converting their interests to Common Stock or receiving par plus accrued interest for the Convertible Senior Notes. The notes were convertible into shares of Common Stock at a conversion rate applicable at the time of each notice. During the first half of 2012, holders of approximately \$147 million of the Convertible Senior Notes outstanding converted their interests into approximately 4.3 million shares of Common Stock. The remaining \$3 million of outstanding Convertible Senior Notes were redeemed at par for cash.

Interest Rate Risk

UNS Energy is subject to interest rate risk resulting from changes in interest rates on its borrowings under the revolving credit facility. The interest paid on revolving credit borrowings is variable. UNS Energy may be required to pay higher rates of interest on borrowings under its revolving credit facility if London Interbank Offered Rate (LIBOR) and other benchmark interest rates increase. See *Item 3. Quantitative and Qualitative Disclosures about Market Risk*, below.

Contractual Obligations

There are no changes in our contractual obligations or other commercial commitments from those reported in our 2011 Annual Report on Form 10-K, other than the following changes in 2012:

| Payment Due in Years Ending December 31, | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 and after | Total |
|---|-----------------------|-------|------|------|------|-------------------|--------|
| | -Millions of Dollars- | | | | | | |
| Long Term Debt ⁽¹⁾ | \$ | \$ | \$ | \$ | \$ | \$ 143 | \$ 143 |
| Purchase Obligations: | | | | | | | |
| Fuel | 2 | 4 | 2 | | | | 8 |
| Purchased Power | 3 | 9 | 1 | 1 | 1 | 7 | 22 |
| Service Agreement | 2 | 2 | | | | | 4 |
| Total Additional Contractual Cash Obligations | \$ 7 | \$ 15 | \$ 3 | \$ 1 | \$ 1 | \$ 150 | \$ 177 |

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- ⁽¹⁾ In 2012, \$177 million of unsecured tax-exempt pollution control bonds and \$16 million of tax-exempt industrial development bonds were issued on behalf of TEP. The bonds bear interest at a rate of 4.50% and are due in March and June of 2030. Proceeds were deposited with a trustee and used, together with \$7 million of internal cash, to redeem \$200 million of 1998 Apache Bonds issued on behalf of TEP. In September 2012, TEP issued \$150 million of 3.85% unsecured notes due March 2023. See Note 4.

Table of Contents**Dividends on Common Stock**

The following table shows the dividends declared to UNS Energy shareholders for 2012:

| Declaration Date | Record Date | Payment Date | Dividend Amount Per Share of Common Stock |
|-------------------|-------------------|--------------------|---|
| February 27, 2012 | March 12, 2012 | March 22, 2012 | \$ 0.43 |
| May 3, 2012 | June 8, 2012 | June 27, 2012 | \$ 0.43 |
| August 2, 2012 | September 5, 2012 | September 26, 2012 | \$ 0.43 |

Income Tax Position

As of September 30, 2012, UNS Energy (on a consolidated basis) and TEP had the following carry-forward amounts:

| | UNS Energy | | TEP | |
|----------------------------|---------------------------------|---------------|---------------------------------|---------------|
| | Amount -Millions of Dollars- | Expiring Year | Amount -Millions of Dollars- | Expiring Year |
| Capital Loss | \$ 8 | 2015 | \$ | N/A |
| Federal Net Operating Loss | 218 | 2031-2032 | 242 | 2031-2032 |
| State Net Operating Loss | 32 | 2032 | 68 | 2032 |
| State Credits | 1 | 2017 | 3 | 2016-2017 |
| AMT Credit | 43 | None | 24 | None |
| Investment Tax Credits | 5 | 2032 | 5 | 2032 |

The 2010 Federal Tax Relief Act includes provisions that make qualified property placed into service between September 8, 2010 and January 1, 2012, eligible for 100% bonus depreciation for tax purposes. The same law makes qualified property placed in service during 2012 eligible for 50% bonus depreciation for tax purposes. In addition, the IRS issued new guidance related to the treatment of expenditures to maintain, replace, or improve property. These provisions are an acceleration of tax benefits UNS Energy and TEP otherwise would have received over 20 years. As a result of these provisions, UNS Energy and TEP did not pay any federal income taxes for the tax year 2011 and does not expect to pay any federal or state income taxes for 2012.

TUCSON ELECTRIC POWER COMPANY**RESULTS OF OPERATIONS**

TEP's financial condition and results of operations are the principal factors affecting the financial condition and results of operations of UNS Energy. The following discussion relates to TEP, unless otherwise noted.

Third Quarter of 2012 Compared with Third Quarter of 2011

TEP reported net income of \$45 million in the third quarter of 2012 compared with net income of \$54 million in the third quarter of 2011. The following factors impacted TEP's results in the third quarter of 2012:

an \$8 million decrease in retail margin revenues. A 12.2% decline in Cooling Degree Days compared with the third quarter of 2011 contributed to a 3.6% decrease in retail kilowatt-hour (kWh) sales;

a \$2 million increase in depreciation and amortization expense as a result of an increase in net plant-in-service;

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a \$2 million decrease in pre-tax income related to the operation of Springerville Units 3 and 4 resulting from an unplanned outage at Springerville Unit 3; and

a \$7 million pre-tax gain recorded in the third quarter of 2011 related to the settlement of a dispute with El Paso Electric; partially offset by

a \$2 million decrease in Base O&M due in part to a decline in unscheduled plant maintenance.

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Nine Months Ended September 30, 2012 Compared with the Nine Months Ended September 30, 2011

TEP reported net income of \$65 million for the first nine months of 2012 compared with net income of \$84 million for the same period in 2011. The following factors impacted TEP's results in the first nine months of 2012:

a \$4 million decrease in retail margin revenues due to a 0.5% decrease in retail kWh sales;

a \$9 million decline in long-term wholesale margin revenues resulting from a change in the pricing of energy sold under the SRP wholesale contract effective June 2011;

a \$3 million decrease in pre-tax income related to Springerville Units 3 and 4 resulting from an unplanned outage at Springerville Unit 3;

a \$9 million increase in depreciation and amortization expense as a result of an increase in net plant-in-service; and

a \$7 million pre-tax gain recorded in the third quarter of 2011 related to the settlement of a dispute with El Paso Electric.

Table of Contents**Utility Sales and Revenues**

Changes in the number of customers, weather, economic conditions, and other factors affect retail sales of electricity. The table below provides a summary of TEP's retail kWh sales, revenues, and weather data during the third quarters of 2012 and 2011:

| Three Months Ended September 30, | 2012 | 2011 | Increase (Decrease) | |
|--|---------------|---------------|---------------------|------------------------|
| <u>Energy Sales, kWh (in Millions):</u> | | | Amount | Percent ⁽¹⁾ |
| Electric Retail Sales: | | | | |
| Residential | 1,332 | 1,417 | (85) | (5.9)% |
| Commercial | 589 | 598 | (9) | (1.5)% |
| Industrial | 616 | 632 | (16) | (2.6)% |
| Mining | 275 | 274 | 1 | 0.3% |
| Public Authorities | 66 | 65 | 1 | 1.0% |
| Total Electric Retail Sales | 2,878 | 2,986 | (108) | (3.6)% |
| Retail Margin Revenues (in Millions): | | | | |
| Residential | \$ 89 | \$ 95 | \$ (6) | (5.8)% |
| Commercial | 49 | 50 | (1) | (1.4)% |
| Industrial | 27 | 29 | (2) | (4.9)% |
| Mining | 9 | 8 | 1 | 3.6% |
| Public Authorities | 3 | 3 | | |
| Total Retail Margin Revenues (Non-GAAP)⁽²⁾ | 177 | 185 | (8) | (4.0)% |
| Fuel and Purchased Power Revenues | 115 | 112 | 3 | 2.6% |
| RES & DSM Revenues | 11 | 12 | (1) | (12.5)% |
| Total Retail Revenues (GAAP) | \$ 303 | \$ 309 | \$ (6) | (1.9)% |
| Average Retail Margin Rate (Cents / kWh): | | | | |
| Residential | 6.67 | 6.66 | 0.01 | 0.2% |
| Commercial | 8.37 | 8.36 | 0.01 | 0.1% |
| Industrial | 4.43 | 4.54 | (0.11) | (2.4)% |
| Mining | 3.13 | 3.03 | 0.10 | 3.3% |
| Public Authorities | 5.15 | 5.20 | (0.05) | (1.0)% |
| Average Retail Margin Revenue | 6.17 | 6.19 | (0.02) | (0.3)% |
| Average Fuel and Purchased Power Revenue | 4.00 | 3.76 | 0.24 | 6.4% |
| Average RES & DSM Revenue | 0.36 | 0.40 | (0.04) | (10.0)% |
| Total Average Retail Revenue | 10.53 | 10.35 | 0.18 | 1.7% |
| Weather Data: | | | | |
| Cooling Degree Days | | | | |
| Three Months Ended September 30, | 957 | 1,090 | (133) | (12.2)% |
| 10-Year Average | 990 | 990 | NM | NM |
| Wholesale Energy Market Indicators: | | | | |
| Power Prices (\$ / MWh) ⁽³⁾ | \$ 30 | \$ 35 | \$ (5) | (14.3)% |
| Natural Gas Prices (\$ / MMBtu) ⁽⁴⁾ | 2.78 | 4.09 | (1.31) | (32.0)% |

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- (1) Percent change is calculated on unrounded data and may not correspond exactly to data shown in table.
- (2) Retail Margin Revenues, a non-GAAP financial measure, should not be considered as an alternative to Total Retail Revenues, which is determined in accordance with GAAP. Retail Margin Revenues exclude: (i) revenues collected from retail customers that are directly offset by expenses recorded in other line items; and (ii) revenues collected from third parties that are unrelated to kWh sales to retail customers. We believe the change in Retail Margin Revenues between periods provides useful information to investors because it demonstrates the underlying revenue trend and performance of our core utility business. Retail Margin Revenues represents the portion of retail operating revenues available to cover the non-fuel operating expenses of our core utility business.
- (3) Around-the-clock market price of energy is based on the Dow Jones Palo Verde Index.
- (4) Average market price for natural gas is based on the Permian Index.

Table of Contents**Residential**

Residential kWh sales were 5.9% lower in the third quarter of 2012 than they were during the same period last year, leading to a decrease in residential margin revenues of 5.8%, or \$6 million. Residential use per customer decreased by 6.4% due in part to a 12.2% decrease in Cooling Degree Days compared with the same period last year. The average number of residential customers grew by 0.5% in the third quarter of 2012 compared with the same period last year.

Commercial

Commercial kWh sales decreased by 1.5% compared with the third quarter of 2011, leading to a decrease in commercial margin revenues of 1.4%, or \$1 million. Commercial use per customer decreased by 1.8% due in part to a 12.2% decrease in Cooling Degree Days compared with the same period last year. The average number of commercial customers grew by 0.3% in the third quarter of 2012 compared with the same period last year.

Industrial

Industrial kWh sales decreased by 2.6% compared with the third quarter of 2011, due in part to regional economic conditions. Industrial margin revenues decreased by \$2 million when compared with the same period of 2011.

Mining

Mining kWh sales increased by 0.3% in the third quarter of 2012 compared with the same period last year. See *Factors Affecting Results of Operations, Sales to Mining Customers*, below.

Wholesale Sales and Transmission Revenues

| Three Months Ended September 30, | 2012 | 2011 |
|--|-----------------------|--------------|
| | -Millions of Dollars- | |
| Long-Term Wholesale Revenues: | | |
| Long-Term Wholesale Margin Revenues (Non-GAAP) ⁽¹⁾ | \$ 1 | \$ 1 |
| Fuel and Purchased Power Expense Allocated to Long-Term Wholesale Revenues | 6 | 8 |
| Total Long-Term Wholesale Revenues | 7 | 9 |
| Transmission Revenues | 4 | 4 |
| Short-Term Wholesale Revenues | 14 | 17 |
| Electric Wholesale Sales (GAAP) | \$ 25 | \$ 30 |

⁽¹⁾ Long-term Wholesale Margin Revenues, a non-GAAP financial measure, should not be considered as an alternative to Electric Wholesale Sales, which is determined in accordance with GAAP. We believe the change in Long-Term Wholesale Margin Revenues between periods provides useful information to investors because it demonstrates the underlying profitability of TEP's long-term wholesale sales contracts. Long-Term Wholesale Margin Revenues represents the portion of long-term wholesale revenues available to cover the operating expenses of our core utility business.

Long-Term Wholesale Margin Revenues were the same when compared with the third quarter of 2011. See *Factors Affecting Results of Operations, Long-Term Wholesale Sales, Salt River Project*, below, for more information.

Short-Term Wholesale Revenues

All revenues from short-term wholesale sales and 10% of the profits from wholesale trading activity are credited against the fuel and purchased power costs eligible for recovery in the Purchased Power and Fuel Adjustment Clause (PPFAC).

Table of Contents**Utility Sales and Revenues**

| Nine Months Ended September 30, | 2012 | 2011 | Increase (Decrease) | |
|--|---------------|---------------|---------------------|------------------------|
| | | | Amount | Percent ⁽¹⁾ |
| Energy Sales, kWh (in Millions): | | | | |
| Electric Retail Sales: | | | | |
| Residential | 3,085 | 3,108 | (23) | (0.8)% |
| Commercial | 1,523 | 1,517 | 6 | 0.4% |
| Industrial | 1,628 | 1,654 | (26) | (1.5)% |
| Mining | 818 | 811 | 7 | 0.8% |
| Public Authorities | 182 | 182 | | (0.3)% |
| Total Electric Retail Sales | 7,236 | 7,272 | (36) | (0.5)% |
| Retail Margin Revenues (in Millions): | | | | |
| Residential | \$ 202 | \$ 203 | \$ (1) | (0.5)% |
| Commercial | 124 | 124 | | 0.6% |
| Industrial | 71 | 73 | (2) | (3.3)% |
| Mining | 23 | 24 | (1) | (3.3)% |
| Public Authorities | 9 | 9 | | |
| Total Retail Margin Revenues (Non-GAAP)⁽²⁾ | 429 | 433 | (4) | (0.8)% |
| Fuel and Purchased Power Revenues | 256 | 245 | 11 | 4.3% |
| RES & DSM Revenues | 32 | 36 | (4) | (11.6)% |
| Total Retail Revenues (GAAP) | \$ 717 | \$ 714 | \$ 3 | 0.4% |
| Average Retail Margin Rate (Cents / kWh): | | | | |
| Residential | 6.53 | 6.52 | 0.01 | 0.2% |
| Commercial | 8.16 | 8.14 | 0.02 | 0.2% |
| Industrial | 4.35 | 4.43 | (0.08) | (1.8)% |
| Mining | 2.83 | 2.95 | (0.12) | (4.1)% |
| Public Authorities | 5.12 | 5.10 | 0.02 | 0.4% |
| Average Retail Margin Revenue | 5.93 | 5.95 | (0.02) | (0.3)% |
| Average Fuel and Purchased Power Revenue | 3.54 | 3.38 | 0.16 | 4.7% |
| Average RES & DSM Revenue | 0.44 | 0.50 | (0.06) | (12.0)% |
| Total Average Retail Revenue | 9.91 | 9.83 | 0.08 | 0.8% |
| Weather Data: | | | | |
| Cooling Degree Days | | | | |
| Nine Months Ended September 30, | 1,523 | 1,480 | 43 | 2.9% |
| 10-Year Average | 1,443 | 1,434 | NM | NM |
| Wholesale Energy Market Indicators: | | | | |
| Power Prices (\$ / MWh) ⁽³⁾ | \$ 25 | \$ 30 | \$ (5) | (16.7)% |
| Natural Gas Prices (\$ / MMBtu) ⁽⁴⁾ | 2.46 | 4.04 | (1.58) | (39.1)% |

(1) Percent change is calculated on unrounded data and may not correspond exactly to data shown in table.

(2)

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Retail Margin Revenues, a non-GAAP financial measure, should not be considered as an alternative to Total Retail Revenues, which is determined in accordance with GAAP. Retail Margin Revenues exclude: (i) revenues collected from retail customers that are directly offset by expenses recorded in other line items; and (ii) revenues collected from third parties that are unrelated to kWh sales to retail customers. We believe the change in Retail Margin Revenues between periods provides useful information to investors because it demonstrates the underlying revenue trend and performance of our core utility business. Retail Margin Revenues represents the portion of retail operating revenues available to cover the non-fuel operating expenses of our core utility business.

- (3) Around-the-clock market price of energy is based on the Dow Jones Palo Verde Index.
- (4) Average market price for natural gas is based on the Permian Index.

Table of Contents**Residential**

Residential kWh sales were 0.8% lower in the first nine months of 2012 than they were during the same period last year, leading to a decrease in residential margin revenues of 0.5%, or \$1 million. Residential use per customer decreased by 1.2% primarily due to cooler summer weather than last year.

Commercial

Commercial kWh sales increased by 0.4% compared with the first nine months of 2011, leading to an increase in margin revenues of 0.6%, or less than \$1 million.

Industrial

Industrial kWh sales decreased by 1.5% compared with the first nine months of 2011. Industrial margin revenues declined by 3.3%, or \$2 million compared with the same period of 2011. The decline in margin revenues was greater than the change in kWh sales due to usage patterns by certain industrial customers that reduced their demand charges paid to TEP.

Mining

The continuation of high copper prices led to increased mining activity, resulting in a 0.8% increase in sales volumes in the first nine months of 2012 compared with the same period last year. Margin revenues from mining customers decreased by 3.3%, or \$1 million, over the same period last year. See *Factors Affecting Results of Operations, Sales to Mining Customers*, below.

Wholesale Sales and Transmission Revenues

| Nine Months Ended September 30, | 2012 | 2011 |
|--|-----------------------|--------------|
| | -Millions of Dollars- | |
| Long-Term Wholesale Revenues: | | |
| Long-Term Wholesale Margin Revenues (Non-GAAP) ⁽¹⁾ | \$ 3 | \$ 12 |
| Fuel and Purchased Power Expense Allocated to Long-Term Wholesale Revenues | 15 | 21 |
| Total Long-Term Wholesale Revenues | 18 | 33 |
| Transmission Revenues | 12 | 12 |
| Short-Term Wholesale Revenues | 47 | 52 |
| Electric Wholesale Sales (GAAP) | \$ 77 | \$ 97 |

⁽¹⁾ Long-Term Wholesale Margin Revenues, a non-GAAP financial measure, should not be considered as an alternative to Electric Wholesale Sales, which is determined in accordance with GAAP. We believe the change in Long-Term Wholesale Margin Revenues between periods provides useful information to investors because it demonstrates the underlying profitability of TEP's long-term wholesale sales contracts. Long-Term Wholesale Margin Revenues represents the portion of long-term wholesale revenues available to cover the operating expenses of our core utility business.

Margin revenues from long-term wholesale contracts were \$9 million lower than in the first nine months of 2011 due primarily to a change in pricing under the SRP contract that took effect in June 2011. See *Factors Affecting Results of Operations, Long-Term Wholesale Sales, Salt River Project*, below, for more information.

Short-Term Wholesale Revenues

All revenues from short-term wholesale sales and 10% of the profits from wholesale trading activity reduce the fuel and purchased power costs eligible for recovery in the PPFAC.

Other Revenues

| | Three Months Ended | | Nine Months Ended | |
|---|-----------------------|-----------------------|--------------------------|-----------------------|
| | September 30, 2012 | September 30, 2011 | September 30, 2012 | September 30, 2011 |
| | -Millions of Dollars- | | -Millions of Dollars- | |
| Revenue related to Springerville Units 3 and 4 ⁽¹⁾ | \$ 31 | \$ 24 | \$ 74 | \$ 74 |
| Other Revenue | 8 | 7 | 22 | 20 |
| Total Other Revenue | \$ 39 | \$ 31 | \$ 96 | \$ 94 |

- ⁽¹⁾ Represents revenues and reimbursements from Tri-State and SRP, owners of Springerville Units 3 and 4, respectively, to TEP related to the operation of these plants.

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In addition to reimbursements related to Springerville Units 3 and 4, TEP's other revenues include inter-company revenues from UNS Gas and UNS Electric for corporate services provided by TEP, and miscellaneous service-related revenues such as rent on power pole attachments, damage claims, and customer late fees.

Operating Expenses**Fuel and Purchased Power Expense**

TEP's fuel and purchased power expense and energy resources for the quarter and nine months ended September 30, 2012 and 2011 are detailed below:

| Three Months Ended September 30, | Generation and Purchased Power | | Fuel and Purchased Power Expense | |
|---|--------------------------------|--------------|----------------------------------|---------------|
| | Power | | Expense | |
| | 2012 | 2011 | 2012 | 2011 |
| | -Millions of kWh- | | -Millions of Dollars- | |
| Coal-Fired Generation | 2,577 | 2,807 | \$ 64 | \$ 73 |
| Gas-Fired Generation | 491 | 331 | 23 | 21 |
| Renewable Generation | 10 | 7 | | |
| Reimbursed Fuel Expense for Springerville Units 3 and 4 | | | 1 | 2 |
| Total Generation | 3,078 | 3,145 | 88 | 96 |
| Total Purchased Power | 759 | 898 | 28 | 40 |
| Transmission | | | 2 | (4) |
| Increase to Reflect PPFAC Recovery Treatment | | | 20 | 1 |
| Total Resources | 3,837 | 4,043 | \$ 138 | \$ 133 |
| Less Line Losses and Company Use | (242) | (255) | | |
| Total Energy Sold | 3,595 | 3,788 | | |

| Nine Months Ended September 30, | Generation and Purchased Power | | Fuel and Purchased Power Expense | |
|---|--------------------------------|---------------|----------------------------------|---------------|
| | Power | | Expense | |
| | 2012 | 2011 | 2012 | 2011 |
| | -Millions of kWh- | | -Millions of Dollars- | |
| Coal-Fired Generation | 7,247 | 7,680 | \$ 182 | \$ 195 |
| Gas-Fired Generation | 1,187 | 707 | 51 | 45 |
| Renewable Generation | 35 | 18 | | |
| Reimbursed Fuel Expense for Springerville Units 3 and 4 | | | 5 | 6 |
| Total Generation | 8,469 | 8,405 | 238 | 246 |
| Total Purchased Power | 1,854 | 2,047 | 62 | 84 |
| Transmission | | | 4 | (2) |
| Increase (Decrease) to Reflect PPFAC Recovery Treatment | | | 25 | (5) |
| Total Resources | 10,323 | 10,452 | \$ 329 | \$ 323 |
| Less Line Losses and Company Use | (669) | (640) | | |

| | | |
|--------------------------|-------|-------|
| Total Energy Sold | 9,654 | 9,812 |
|--------------------------|-------|-------|

Generation

Total generating output decreased during the third quarter and first nine months of 2012 compared with the same periods last year due to lower retail kWh sales. Coal-fired generation decreased by 8% in the third quarter and by 6% in the first nine months of 2012 due in part to the use of natural gas to fuel Sundt Generating Station (Sundt) Unit 4 instead of higher priced contracted coal.

Table of Contents**Purchased Power**

Purchased power volumes decreased in the third quarter of 2012 compared with the same period last year primarily due to a 3.6% decrease in retail kWh sales.

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------|-------------------------------------|------|------------------------------------|------|
| | 2012 | 2011 | 2012 | 2011 |
| | -cents per kWh- | | -cents per kWh - | |
| Coal | 2.49 | 2.62 | 2.50 | 2.53 |
| Gas | 4.69 | 6.26 | 4.31 | 6.42 |
| Purchased Power | 3.63 | 4.51 | 3.35 | 4.11 |
| All Sources | 3.28 | 3.49 | 3.15 | 3.35 |

O&M

The table below summarizes the items included in TEP's O&M expense. See *Results of Operations, Third Quarter of 2012 Compared with Third Quarter of 2011*, above for more information.

| | Three Months | | Nine Months | |
|--|-----------------------------|--------------|-----------------------------|---------------|
| | Ended September 30, 2012 | 2011 | Ended September 30, 2012 | 2011 |
| | -Millions of Dollars- | | -Millions of Dollars- | |
| Base O&M (Non-GAAP) ⁽¹⁾ | \$ 53 | \$ 55 | \$ 173 | \$ 173 |
| O&M Recorded in Other Expense | (1) | (1) | (3) | (6) |
| Reimbursed Expenses Related to Springerville Units 3 and 4 | 26 | 16 | 53 | 49 |
| Expenses Related to Customer Funded Renewable Energy and DSM Programs ⁽²⁾ | 9 | 10 | 25 | 30 |
| Total O&M (GAAP) | \$ 87 | \$ 80 | \$ 248 | \$ 246 |

⁽¹⁾ Base O&M is a non-GAAP financial measure and should not be considered as an alternative to O&M, which is determined in accordance with GAAP. TEP believes that Base O&M, which is O&M less reimbursed expenses and expenses related to customer-funded renewable energy and DSM programs, provides useful information to investors.

⁽²⁾ Represents expenses related to customer-funded renewable energy and DSM programs; these expenses are being collected from customers and the corresponding amounts are recorded in retail revenue.

FACTORS AFFECTING RESULTS OF OPERATIONS**Base Rate Increase Moratorium**

Pursuant to the 2008 TEP Rate Order issued by the ACC, TEP's Base Rates are frozen through at least December 31, 2012. The 2008 TEP Rate Order also prohibited TEP from submitting an application for new Base Rates before June 30, 2012. See *2012 TEP Rate Case*, below, for more information. Adjustor mechanisms, such as TEP's PPFAC, may change from time to time as approved by the ACC.

Notwithstanding the rate increase moratorium, Base Rates and adjustor mechanisms may change under emergency conditions beyond TEP's control if the ACC concludes such changes are required to protect the public interest. The moratorium does not preclude TEP from seeking rate relief in the event of the imposition of a federal carbon tax or related federal carbon regulations.

Table of Contents**2012 TEP Rate Case**

On July 2, 2012, TEP filed a rate request with the ACC. As set forth in the 2008 Settlement Agreement, the parties to the settlement agreed to use their best efforts to have new rates in place no later than 13 months after TEP's next rate application is filed with the ACC. In accordance with this provision, TEP's rate application requests that new rates become effective no later than August 1, 2013. The rate application is based on a test year ended December 31, 2011.

The key provisions of TEP's rate request include:

an increase in non-fuel retail base rates of \$127.8 million, or 15.3%, over adjusted test year revenues;

an original cost rate base of \$1.5 billion, which includes approximately \$40 million of post test year adjustments for utility plant that is expected to be in service by December 31, 2012;

a fair value rate base of \$2.3 billion with a proposed rate of return on fair value rate base of 5.68%; and

the following cost of capital and pro forma capital structure:

| | Component Cost | % of Pro Forma Capital Structure | Weighted Average Cost |
|----------------|-------------------|--|-----------------------|
| Common Equity | 10.75% | 46.00% | 4.94% |
| Long-Term Debt | 5.18% | 54.00% | 2.80% |
| Total | | 100.00% | 7.74% |

Lost Fixed Cost Recovery Mechanism

TEP proposed a Lost Fixed Cost Recovery (LFCR) mechanism that would allow TEP to recover non-fuel costs that would otherwise go unrecovered due to lost kWh sales attributed to: (i) compliance with the ACC's Electric Energy Efficiency Standards (Electric EE Standards); and (ii) distributed generation requirements under the ACC's RES. The LFCR is not a full decoupling mechanism and is not intended to recover lost fixed costs attributable to weather or economic conditions.

Energy Efficiency Resource Plan

TEP proposed a three-year pilot program that would allow TEP to invest in energy efficiency programs in order to meet the ACC's Electric EE Standards in the most cost-effective manner. Electric EE Standards investments would be considered regulatory assets and amortized over a four-year period. TEP would earn a return on its investments and recover the return and amortization expense through the existing demand-side management surcharge.

Environmental Compliance Adjustor (ECA)

TEP proposed a new adjustor mechanism designed to recover the costs of complying with environmental standards required by federal or other governmental agencies between rate cases. The ECA surcharge would be adjusted annually to recover the capital carrying costs on environmental projects under construction, a return on investment, depreciation expense, taxes, and associated O&M costs for completed projects.

Table of Contents**Procedural Schedule**

In September 2012, the administrative law judge assigned to TEP's rate case issued a procedural schedule. The schedule calls for ACC Staff and intervenor testimony to be filed on December 21, 2012, settlement discussions to begin January 15, 2013, and hearings before the administrative law judge on March 6, 2013.

TEP cannot predict the outcome of this proceeding or whether its rate request will be adopted by the ACC in whole or in part.

Purchased Power and Fuel Adjustment Clause

In February 2012, TEP filed its annual PPFAC update report with the ACC. TEP requested an increase in the total PPFAC rate of \$77 million to recover under-collected fuel and purchased power costs of approximately \$51 million and an increase in forecasted fuel and purchased power costs of approximately \$26 million. In March 2012, the ACC approved a PPFAC rate of 0.77 cents per kWh effective April 2012. The new PPFAC rate is expected to provide recovery of approximately \$70 million of fuel and purchased power costs over the period of April 2012 through March 2013. Any shortfall not collected under the approved PPFAC rate is expected to be recovered through the PPFAC rate set for the period beginning April 1, 2013. At September 30, 2012, TEP had under-collected fuel and purchased power costs on a billed-to-customer basis of \$30 million.

Springerville Units 3 and 4

TEP operates and receives annual benefits in the form of rental payments and other fees and cost savings from operating Springerville Unit 3 on behalf of Tri-State and Unit 4 on behalf of SRP.

In 2011, the annual impact to TEP's pre-tax income resulting from operating Springerville Units 3 and 4 was approximately \$24 million. In TEP's 2012 rate case application, TEP proposed passing onto customers approximately \$14 million of these pre-tax benefits, thereby lowering the requested amount of rate relief.

TEP recorded pre-tax income of \$4 million in the third quarter of 2012 and \$6 million in the third quarter of 2011 related to the operation of these units. Results in the third quarter of 2012 were negatively affected by an unplanned outage at Springerville Unit 3. In the third quarter of 2012, TEP recorded a pre-tax loss of \$2 million because the outage will prevent TEP from meeting certain availability requirements under the terms of TEP's operating agreement with Tri-State. TEP expects the Springerville Unit 3 outage to reduce TEP's 2012 pre-tax income by approximately \$3 million.

The table below summarizes the income statement line items in which TEP records revenues and expenses related to Springerville Units 3 and 4:

| | Three Months | | Nine Months | |
|-------------------------------|--------------------------|-------------|--------------------------|--------------|
| | Ended September 30, 2012 | 2011 | Ended September 30, 2012 | 2011 |
| | -Millions of Dollars- | | -Millions of Dollars- | |
| Other Revenues | \$ 31 | \$ 24 | \$ 74 | \$ 74 |
| Fuel Expense | (1) | (2) | (5) | (6) |
| O&M Expense | (26) | (16) | (53) | (49) |
| Taxes Other Than Income Taxes | | | (1) | (1) |
| Total Pre-Tax Income | \$ 4 | \$ 6 | \$ 15 | \$ 18 |

Table of Contents**Pension and Postretirement Benefit Expense**

The table below summarizes TEP's pension and other postretirement benefit expenses recorded as part of O&M in 2012 and 2011. See Note 7.

| | Three Months | | Nine Months | |
|---|-----------------------------|-------------|-----------------------------|--------------|
| | Ended September 30, 2012 | 2011 | Ended September 30, 2012 | 2011 |
| | -Millions of Dollars- | | -Millions of Dollars- | |
| Pension Expense Charged to O&M | \$ 3 | \$ 2 | \$ 8 | \$ 7 |
| Other Postretirement Benefit Expense Charged to O&M | 1 | 1 | 3 | 3 |
| Total | \$ 4 | \$ 3 | \$ 11 | \$ 10 |

In 2012, TEP expects to record approximately \$15 million of pension and other postretirement benefit expense as part of O&M, compared with \$14 million in 2011.

Long-Term Wholesale Sales

TEP's two primary long-term wholesale contracts are with SRP and the Navajo Tribal Utility Authority (NTUA).

Salt River Project

Prior to June 2011, under the terms of the SRP contract, TEP received a monthly demand charge of approximately \$1.8 million, or \$22 million annually, and sold the energy at a price based on TEP's average fuel cost. From June 2011 to December 2011, SRP was required to purchase 73,000 MWh per month. From January 1, 2012 through the end of the contract in May 2016, SRP is required to purchase 500,000 MWh of on-peak energy per year. TEP does not receive a demand charge and the price of energy is based on a discount to the price of on-peak power on the Dow Jones Palo Verde Market Index.

Navajo Tribal Utility Authority

TEP serves the portion of NTUA's load that is not served from NTUA's allocation of federal hydroelectric power. Over the last three years, sales to NTUA averaged 225,000 MWh. The power sold to NTUA is at a fixed price except for 50% of the MWh sales from June to September, which are based on the Dow Jones Palo Verde Market Index. Similar to 2011, we expect approximately 12% of the total energy sold to NTUA in 2012 will be priced based on the Dow Jones Palo Verde Market Index. The NTUA contract expires in December 2015.

Long-Term Wholesale Margin and Sensitivity

TEP's margin on long-term wholesale sales was \$3 million during the first nine months of 2012, compared with \$12 million in the same period last year.

TEP estimates its margin on long-term wholesale sales in 2012 will be \$4 million, compared with \$13 million in 2011. The estimated decrease is a result of changes in the terms of the SRP contract described above. As of October 22, 2012, the average forward price of on-peak power on the Dow Jones Palo Verde Market Index for the remainder of calendar year 2012 was \$34 per MWh. A change of \$5 per MWh in the on-peak market price of power on the Dow Jones Palo Verde Market Index for the balance of the year would change 2012 pre-tax income related to the SRP contract by less than \$1 million.

Electric Energy Efficiency Standards

In August 2010, the ACC approved new Electric EE Standards designed to require TEP, UNS Electric, and other affected electric utilities to implement cost-effective programs to reduce customers' energy consumption. In 2011, TEP's programs saved energy equal to approximately 1.4% of its 2010 retail kWh sales. In 2012, the Electric EE Standards target total kWh savings of 3% of 2011 retail kWh sales. The Electric EE Standards increase annually thereafter up to a targeted cumulative annual reduction in retail kWh sales of 22% by 2020.

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

In May 2012, TEP filed a modification to its proposed 2011-2012 Energy Efficiency Implementation Plan with the ACC. The proposal includes a request for a performance incentive ranging from approximately \$3 million to \$4 million pre-tax that would be recorded in 2012 upon ACC approval. In August 2012, an administrative law judge issued a recommended opinion and order that proposed the adoption of TEP's plan. TEP cannot predict when or if the ACC will issue a final order in this matter. TEP has not recorded income related to the proposed performance incentive in 2012.

Decoupling

In December 2010, the ACC issued a policy statement recognizing the need to adopt rate decoupling or another mechanism to make Arizona's Electric EE Standards viable. A decoupling mechanism is designed to encourage energy conservation by restructuring utility Retail Rates to separate the recovery of fixed costs from the level of energy consumed. The policy statement allows affected utilities to file rate decoupling proposals in their next general rate case. TEP filed a general rate case in July 2012 which included a request for a partial decoupling mechanism. See *2012 TEP Rate Case, Lost Fixed Cost Recovery Mechanism*, above.

Renewable Energy Standard and Tariff

In December 2011, the ACC approved TEP's RES implementation plan including investments of \$28 million in 2012 and \$8 million in 2013 for company-owned solar projects. In 2011, TEP's renewable energy investments totaled \$28 million. In accordance with the funding mechanism approved by the ACC, TEP could earn approximately \$1 million pre-tax in 2012 on solar investments made in 2010 and 2011 and approximately \$3 million pre-tax in 2013.

In July 2012, TEP filed its 2013 RES implementation plan. TEP's plan proposes to collect approximately \$41 million from customers during 2013. The plan includes a proposal to invest \$28 million in 2013 for company-owned solar projects, of which \$8 million was previously approved by the ACC, as well as the continuation of the funding mechanism for company-owned solar projects. TEP cannot predict if or when the ACC will approve its plan.

Competition

New technological developments and the implementation of the ACC's Electric EE Standards may reduce energy consumption by TEP's retail customers. TEP's customers also have the ability to install renewable energy technologies and conventional generation units that could reduce their reliance on TEP's services. Self-generation by TEP's customers has not had a significant impact to date. In the wholesale market, TEP competes with other utilities, power marketers, and independent power producers in the sale of electric capacity and energy.

Retail Electric Competition Rules

In 1999, the ACC approved the Retail Electric Competition Rules (Rules) that provided a framework for the introduction of retail electric competition in Arizona. Certain portions of the ACC Rules that enabled Electric Service Providers (ESPs) to compete in the retail market were invalidated by an Arizona Court of Appeals decision in 2004. In 2008, the ACC opened an administrative proceeding to address the Rules but has since taken no action. During 2012, a small number of companies filed applications for a Certificate of Convenience and Necessity (CC&N) with the ACC to provide competitive retail electric services in TEP's service territory as an ESP. Unless and until the ACC clarifies the Rules and/or grants a CC&N to an ESP, it is not possible for TEP's retail customers to use an alternative ESP. We cannot predict what changes, if any, the ACC will make to the Rules or if the ACC will grant a CC&N to an ESP.

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Sales to Mining Customers

In the first nine months of 2012, kWh sales to TEP's mining customers increased 0.8% compared with the same period last year. See *Utility Sales and Revenues, Mining*, above for more information.

In December 2011, a mining customer's long-term contract expired and in January 2012 the customer converted to a time-of-use rate. As a result, we expect full year 2012 margin revenues from mining customers will be approximately \$1 million lower than 2011.

Continued pricing of copper above \$3 per pound triggered an increase in mining activity at copper mines operating in TEP's service area. TEP's mining customers have indicated they are taking initial steps to increase production either through expansion of their current mining operations or by the re-opening of non-operational mine sites. If efforts to increase production are successful, TEP's mining load could increase by up to 100 MW over the next several years. The market price for copper and the ability to obtain necessary permits could affect the mining industry's expansion plans.

In addition to mining customers TEP currently serves, Augusta Resources Corporation filed a plan of operations with the United States Forest Service in 2007 for the proposed Rosemont Copper Mine near Tucson, Arizona. The Rosemont Copper Mine requires electric service from TEP via a 138 kilo-volt (kV) transmission line for the construction and ongoing operation of the mine. A certificate of environmental compatibility (CEC) from the state line siting committee was approved in December 2011 for the 138 kV transmission line. In June 2012, the ACC finalized the CEC. If the Rosemont Copper Mine were to reach full production, it would be expected to become TEP's largest retail customer, with TEP serving approximately 90 MW of the mine's total estimated load of approximately 100 MW.

TEP cannot predict if or when existing mines will expand operations or new or re-opened mines will commence operations.

Interest Rates

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, 2012, TEP had \$215 million in tax-exempt variable rate debt outstanding. The interest rates on TEP's tax-exempt variable rate debt are reset weekly by its remarketing agents. The maximum interest payable under the indentures for the bonds is 10% on \$37 million of bonds and 20% on the other \$178 million. During the first nine months of 2012, the average rates paid ranged from 0.06% to 0.26%. At October 22, 2012, the average rate on the debt was 0.21%.

TEP has a fixed-for-floating interest rate swap to hedge \$50 million of its tax-exempt variable rate debt.

TEP is also subject to interest rate risk resulting from changes in interest rates on its borrowings under the revolving credit facility. The interest paid on revolving credit borrowings is variable. If LIBOR and other benchmark interest rates increase, TEP may 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*, below.

Fair Value Measurements

TEP's income statement exposure to energy price risk is mitigated as TEP reports the change in fair value of energy contract derivatives as either a regulatory asset or regulatory liability, or as a component of other comprehensive income, rather than in the income statement. See Note 9.

Table of Contents**LIQUIDITY AND CAPITAL RESOURCES****TEP Cash Flows**

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

| Nine Months Ended September 30, | 2012 | 2011 |
|---|-----------------------|---------|
| | -Millions of Dollars- | |
| Net Cash Flows Operating Activities (GAAP) | \$ 207 | \$ 206 |
| Amounts from Statements of Cash Flows: | | |
| Less: Capital Expenditures | (196) | (194) |
| Net Cash Flows after Capital Expenditures (Non-GAAP) ⁽¹⁾ | 11 | 12 |
| Amounts From Statements of Cash Flows: | | |
| Less: Retirement of Capital Lease Obligations | (89) | (74) |
| Plus: Proceeds from Investment in Lease Debt | 19 | 38 |
| Net Cash Flows after Capital Expenditures and Required Payments on Debt and Capital Lease Obligations (Non-GAAP) ⁽¹⁾ | \$ (59) | \$ (24) |

| Nine Months Ended September 30, | 2012 | 2011 |
|---|-----------------------|--------|
| | -Millions of Dollars- | |
| Net Cash Flows Operating Activities (GAAP) | \$ 207 | \$ 206 |
| Net Cash Flows Investing Activities (GAAP) | (173) | (153) |
| Net Cash Flows Financing Activities (GAAP) | 41 | (58) |
| Net Cash Flows after Capital Expenditures (Non-GAAP) ⁽¹⁾ | 11 | 12 |
| Net Cash Flows after Capital Expenditures and Required Payments on Debt and Capital Lease Obligations (Non-GAAP) ⁽¹⁾ | (59) | (24) |

⁽¹⁾ Net Cash Flows after Capital Expenditures and Net Cash Flows after Capital Expenditures and Required Payments on Debt and Capital Lease Obligations, 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. We believe that Net Cash Flows after Capital Expenditures and Net Cash Flows after Capital Expenditures and Required Payments on Debt and Capital Lease Obligations provide useful information to investors as measures of TEP's ability to fund capital requirements, make required principal payments on debt and capital lease obligations, and pay dividends to UNS Energy.

Liquidity Outlook

During 2012, TEP expects to generate sufficient operating cash flows to fund the majority of its capital expenditures. 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 assist in funding its business activities.

Operating Activities

In the first nine months of 2012, net cash flows from operating activities were \$1 million higher than in the first nine months of 2011 due primarily to:

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an \$18 million decrease in O&M costs and wages paid, due to lower renewable energy incentive payments, lower payments related to the operation of Springerville Units 3 and 4, and lower pension contribution payments; and

a \$4 million decrease in capital lease interest paid due to a decline in capital lease obligation balances; partially offset by

a \$6 million decrease in cash receipts from electric sales (net of fuel and purchased power costs) due in part to lower long-term wholesale margins and an increase in coal inventories compared with the first nine months of 2011;

a \$4 million decrease in income tax refunds received;

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a \$3 million decrease in interest received on investments in lease debt due to a lower balance in investment in lease debt;

a \$2 million increase in interest paid, net of amounts capitalized, due in part to the issuance of fixed rate long-term debt in November 2011; and

a \$6 million increase in taxes other than income taxes paid due in part to higher property taxes paid.

Investing Activities

Net cash flows used for investing activities increased by \$20 million in the first nine months of 2012 compared with the same period last year due primarily to lower proceeds from the return of investment in Springerville lease debt.

TEP's capital expenditures were \$196 million in the first nine months of 2012, compared with \$194 million in the same period last year. TEP's estimated capital expenditures for 2012 are \$287 million.

Financing Activities

In the first nine months of 2012, net cash from financing activities was \$99 million higher than in the same period in 2011 due to:

a \$132 million increase in proceeds from the issuance of long-term debt (net of repayments); partially offset by

a \$15 million decrease in borrowings (net of repayments) made under TEP's Revolving Credit Facility; and

a \$15 million increase in scheduled payments on capital lease obligations.

TEP Credit Agreement

The TEP Credit Agreement consists of a \$200 million revolving credit and revolving letter of credit facility and a \$186 million letter of credit facility to support tax-exempt bonds. The TEP Credit Agreement expires in November 2016 and is secured by \$386 million of Mortgage Bonds. As of September 30, 2012, there were no outstanding borrowings and \$1 million of LOCs issued under the TEP Revolving Credit Facility.

The TEP Credit Agreement contains restrictions on liens, mergers, and sale of assets. The TEP Credit Agreement also requires TEP not to exceed a maximum leverage ratio. If TEP complies with the terms of the TEP Credit Agreement, TEP may pay dividends to UNS Energy. As of September 30, 2012, TEP was in compliance with the terms of the TEP Credit Agreement.

2010 TEP Reimbursement Agreement

In December 2010, TEP entered into a four-year \$37 million reimbursement agreement (2010 TEP Reimbursement Agreement). A \$37 million LOC was issued pursuant to the 2010 TEP Reimbursement Agreement. The LOC supports \$37 million aggregate principal amount of variable rate tax-exempt pollution control bonds that were issued on behalf of TEP in December 2010.

The 2010 TEP Reimbursement Agreement contains substantially the same restrictive covenants as the TEP Credit Agreement described above. As of September 30, 2012, TEP was in compliance with the terms of the 2010 TEP Reimbursement Agreement.

Table of Contents**2012 Bond Issuances and Redemptions**

In March 2012, \$177 million of unsecured tax-exempt pollution control bonds were issued on behalf of TEP. The bonds bear interest at a fixed rate of 4.50%, mature in March 2030 and may be redeemed at par on or after March 1, 2022. In April 2012, the proceeds of the bond issuance, as well as \$7 million of internal cash, were used to redeem \$184 million of unsecured tax-exempt bonds with interest rates of 5.85% and 5.875%, and maturity dates ranging from 2026 to 2033. See Note 4.

In June 2012, approximately \$16 million of unsecured tax-exempt industrial development bonds were issued on behalf of TEP. The bonds bear interest at a fixed rate of 4.50%, mature in June 2030 and may be redeemed at par on or after June 1, 2022. In July 2012, the proceeds of the bond issuance were used to redeem approximately \$16 million of unsecured tax-exempt bonds with interest rates of 5.85% and 5.875%, and maturity dates ranging from 2026 to 2033. See Note 4.

In September 2012, TEP issued \$150 million in unsecured notes due in March 2023. The notes bear interest at 3.85% and are callable at par beginning in December 2022. Prior to December 2022, the notes are callable with a make-whole redemption premium. The notes contain a limitation on the amount of secured debt that TEP may have outstanding. TEP used the net proceeds from the sale of the notes to repay borrowings under its revolving credit facility and for general corporate purposes.

Capital Lease Obligations

As of September 30, 2012, TEP had \$351 million of total capital lease obligations on its balance sheet. The table below provides a summary of the outstanding lease obligations:

| Leases | Capital Lease Obligation Balance | Expiration | Renewal/Purchase Option |
|--|---|---------------|---|
| | As of September 30, 2012 -Millions of Dollars- | | |
| Springerville Unit 1 ⁽¹⁾ | \$197 | 2015 | Fair market value purchase option of \$159 million ⁽²⁾ |
| Springerville Coal Handling Facilities Lease | 48 | 2015 | Fixed price purchase option of \$120 million ⁽³⁾ |
| Springerville Common Facilities ⁽⁴⁾ | 106 | 2017 and 2021 | Fixed price purchase option of \$106 million ⁽³⁾ |
| Total Capital Lease Obligations | \$351 | | |

⁽¹⁾ The Springerville Unit 1 Leases cover both Unit 1 and an undivided one-half interest in certain Springerville Common Facilities.

⁽²⁾ As determined in December 2011 in an appraisal procedure undertaken pursuant to the Springerville Unit 1 lease agreements. See Part II, Item 1. Legal Proceedings.

⁽³⁾ TEP agreed with Tri-State, the owner of Springerville Unit 3 and SRP, the owner of Springerville Unit 4, that if the Springerville Coal Handling Facilities and Common Leases are not renewed, TEP will exercise the purchase options under these contracts. SRP will then be obligated to buy a portion of these facilities and Tri State will then be obligated to either 1) buy a portion of these facilities; or 2) continue making payments to TEP for the use of these facilities.

⁽⁴⁾ The Springerville Common Facilities Leases cover an undivided one-half interest in certain Springerville Common Facilities.

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Except for TEP's 14% equity ownership in 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 and associated Common Facilities is for fair market value as determined at that time, whereas the purchase price option is fixed for the Springerville Coal Handling Facilities and the remaining Common Facilities. See *Part II, Item 1. Legal Proceedings*.

Table of Contents**Income Tax Position**

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

Contractual Obligations

There have been no changes in TEP's contractual obligations or other commercial commitments from those reported in our 2011 Annual Report on Form 10-K, other than the following changes in 2012:

| Payment Due in Years Ending December 31, | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | Total |
|--|-----------------------|-------------|-------------|-------------|-------------|---------------|---------------|
| | | | | | | and after | |
| | -Millions of Dollars- | | | | | | |
| Long Term Debt ⁽¹⁾ | \$ | \$ | \$ | \$ | \$ | \$ 143 | \$ 143 |
| Purchase Obligations | | | | | | | |
| Purchased Power | 1 | 1 | 1 | 1 | 1 | 7 | 12 |
| Service Agreement | 2 | 2 | | | | | 4 |
| Total Additional Contractual Cash Obligations | \$ 3 | \$ 3 | \$ 1 | \$ 1 | \$ 1 | \$ 150 | \$ 159 |

⁽¹⁾ In 2012, \$177 million of unsecured tax-exempt pollution control bonds and \$16 million of tax-exempt industrial development bonds were issued on behalf of TEP. The bonds bear interest at a rate of 4.5% and are due in March and June of 2030. Proceeds were deposited with a trustee and used, together with \$7 million of internal cash, to redeem \$200 million of 1998 Apache Bonds issued on behalf of TEP. In September 2012, TEP issued \$150 million of 3.85% unsecured notes due March 2023. See Note 4.

Dividends on Common Stock

TEP can pay dividends if it maintains compliance with the TEP Credit Agreement and the 2010 TEP Reimbursement Agreement. As of September 30, 2012, TEP was in compliance with the terms of the TEP Credit Agreement and the 2010 TEP Reimbursement Agreement.

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

TEP paid a \$30 million dividend to UNS Energy in October 2012.

Table of Contents**UNS GAS****RESULTS OF OPERATIONS**

UNS Gas reported a net loss of less than \$1 million in the third quarter of 2012 compared with a net loss of \$1 million in the same period last year. In the first nine months of 2012, UNS Gas reported net income of \$5 million compared with net income of \$6 million in the same period last year. The decrease in net income is due in part to mild weather during the first nine months of 2012 compared with the first nine months of 2011. The table below provides summary financial information for UNS Gas:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|---------------|--|-------------|
| | 2012 | 2011 | 2012 | 2011 |
| | -Millions of Dollars- | | -Millions of Dollars- | |
| Gas Revenues | \$ 18 | \$ 18 | \$ 90 | \$ 101 |
| Other Revenues | | | 3 | 2 |
| Total Operating Revenues | 18 | 18 | 93 | 103 |
| Purchased Gas Expense | 8 | 9 | 49 | 60 |
| Increase to Reflect PGA Recovery Treatment | | | 3 | 1 |
| O&M | 6 | 5 | 19 | 19 |
| Depreciation and Amortization | 2 | 2 | 6 | 6 |
| Taxes Other Than Income Taxes | 1 | 1 | 3 | 2 |
| Total Other Operating Expenses | 17 | 17 | 80 | 88 |
| Operating Income | 1 | 1 | 13 | 15 |
| Interest Expense | 2 | 2 | 5 | 5 |
| Income Tax Expense (Benefit) | (1) | | 3 | 4 |
| Net Income/(Loss) | \$ | \$ (1) | \$ 5 | \$ 6 |

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The tables below include UNS Gas term sales and margin revenues for the third quarters of 2012 and 2011:

| Three Months Ended September 30, | 2012 | 2011 | Increase (Decrease) | |
|--|--------------|--------------|---------------------|------------------------|
| | | | Amount | Percent ⁽¹⁾ |
| -Millions of Therms- | | | | |
| Gas Retail Sales: | | | | |
| Residential | 5 | 5 | | (1.1)% |
| Commercial | 4 | 4 | | (2.9)% |
| Industrial | | 1 | (1) | (31.3)% |
| Public Authorities | | | | (0.3)% |
| Total Gas Retail Sales | 9 | 10 | (1) | (3.1)% |
| Negotiated Sales Program (NSP) | 11 | 6 | 5 | 76.7% |
| Total Gas Sales | 20 | 16 | 4 | 27.1% |
| -Millions of Dollars- | | | | |
| Retail Margin Revenues: | | | | |
| Residential | \$ 6 | \$ 6 | \$ | 1.8% |
| Commercial | 2 | 2 | | 12.5% |
| Industrial | | | | |
| Public Authorities | | | | |
| Total Retail Margin Revenues (Non-GAAP)⁽²⁾ | 8 | 8 | | 4.0% |
| Transport and NSP | 5 | 4 | 1 | 30.6% |
| Retail Fuel Revenues | 5 | 6 | (1) | (24.2)% |
| Total Gas Revenues (GAAP) | \$ 18 | \$ 18 | \$ | |
| Weather Data: | | | | |
| Heating Degree Days | | | | |
| Three Months Ended September 30, | 243 | 240 | 3 | 1.3% |
| 10-Year Average | 319 | 330 | NM | NM |

⁽¹⁾ Percent change calculated on unrounded data and may not correspond exactly to data shown in table.

⁽²⁾ Total Retail Margin Revenues, a non-GAAP financial measure, should not be considered as an alternative to Total Gas Revenues, which is determined in accordance with GAAP. Total Retail Margin Revenues excludes revenues collected from retail customers that are directly offset by expenses recorded in other line items. We believe the change in Total Retail Margin Revenues between periods provides useful information to investors because it demonstrates the underlying revenue trend and performance of our core utility business. Total Retail Margin Revenues represents the portion of retail operating revenues available to cover the non-fuel operating expenses of our core utility business.

Retail term sales during the third quarter of 2012 decreased by 3.1%; however, retail margin revenues increased by 4.0%, or \$300 thousand, compared with the third quarter of 2011 due to the Base Rate increase implemented in May 2012.

UNS Gas supplies natural gas to some of its large transportation customers through an NSP. 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.

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| Nine Months Ended September 30, | 2012 | 2011 | Increase (Decrease) | |
|--|--------|--------|---------------------|------------------------|
| | | | Amount | Percent ⁽¹⁾ |
| -Millions of Therms- | | | | |
| Gas Retail Sales: | | | | |
| Residential | 44 | 48 | (4) | (7.6)% |
| Commercial | 20 | 21 | (1) | (5.5)% |
| Industrial | 1 | 2 | (1) | (17.6)% |
| Public Authorities | 4 | 4 | | (10.8)% |
| Total Gas Retail Sales | 69 | 75 | (6) | (7.4)% |
| NSP | 26 | 19 | 7 | 32.8% |
| Total Gas Sales | 95 | 94 | 1 | 0.9% |
| -Millions of Dollars- | | | | |
| Retail Margin Revenues: | | | | |
| Residential | \$ 27 | \$ 28 | \$ (1) | (2.9)% |
| Commercial | 7 | 7 | | |
| Industrial | | | | |
| Public Authorities | 1 | 1 | | |
| Total Retail Margin Revenues (Non-GAAP)⁽²⁾ | 35 | 36 | (1) | (2.2)% |
| DSM Revenues | 1 | 1 | | (12.5)% |
| Transport and NSP | 12 | 13 | (1) | (3.2)% |
| Retail Fuel Revenues | 42 | 51 | (9) | (19.0)% |
| Total Gas Revenues (GAAP) | \$ 90 | \$ 101 | \$ (11) | (11.0)% |
| Weather Data: | | | | |
| Heating Degree Days | | | | |
| Nine Months Ended September 30, | 13,745 | 15,464 | (1,719) | (11.1)% |
| 10-Year Average | 12,671 | 12,742 | NM | NM |

(1) Percent change calculated on unrounded data and may not correspond exactly to data shown in table.

(2) Total Retail Margin Revenues, a non-GAAP financial measure, should not be considered as an alternative to Total Gas Revenues, which is determined in accordance with GAAP. Total Retail Margin Revenues excludes revenues collected from retail customers that are directly offset by expenses recorded in other line items. We believe the change in Total Retail Margin Revenues between periods provides useful information to investors because it demonstrates the underlying revenue trend and performance of our core utility business. Total Retail Margin Revenues represents the portion of retail operating revenues available to cover the non-fuel operating expenses of our core utility business.

FACTORS AFFECTING RESULTS OF OPERATIONS**Competition**

New technological developments and the implementation of the ACC's Gas Energy Efficiency Standards (Gas EE Standards) may reduce energy consumption by UNS Gas retail customers. Customers of UNS Gas also have the ability to switch from gas to an alternate energy source that could reduce their reliance on services provided by UNS Gas.

Rates2012 UNS Gas Rate Order

In April 2012, the ACC approved a Base Rate increase of \$2.7 million as well as a LFCR mechanism to enable UNS Gas to recover lost fixed-cost revenues as a result of implementing the Gas EE Standards. The LFCR is expected to recover lost fixed-cost revenues of less than

\$0.1 million in 2013, based on estimated lost retail therm sales from May through December 2012.

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The new rates became effective on May 1, 2012. The impact of the Base Rate increase on customers' bills is offset by a temporary credit adjustment to the PGA. See *Purchased Gas Adjustor*, below, for more information.

Purchased Gas Adjustor

The PGA mechanism is intended to address the volatility of natural gas prices and allow UNS Gas to recover its actual commodity costs, including transportation, through a price adjustor. The difference between UNS Gas' actual monthly gas and transportation costs and the rolling 12-month average cost of gas and transportation is deferred and recovered or returned to customers through the PGA mechanism.

The PGA mechanism has two components, the PGA factor and the PGA surcharge or credit. The PGA factor is a mechanism that calculates the twelve-month rolling weighted average gas cost and automatically adjusts monthly, subject to limitations on how much the price per therm may change in a 12-month period. The annual cap on the maximum increase in the PGA factor is 15 cents per therm in a 12-month period.

At any time UNS Gas' PGA balancing account, called the PGA bank balance, is under-recovered, UNS Gas may request a PGA surcharge with the goal of collecting the amount deferred from customers over a period deemed appropriate by the ACC. When the PGA bank balance reaches an over-collected balance of \$10 million on a billed-to-customer basis, UNS Gas is required to make a filing with the ACC to determine how the over-collected balance should be returned to customers.

In April 2012, the ACC approved the temporary PGA surcredit adjustment of 4.5 cents per therm which became effective on May 1, 2012, and will continue through April 2014. The credit adjustment over this period is expected to return approximately \$10 million of over-collected PGA costs to customers. At September 30, 2012, the PGA bank balance was over-collected by \$17 million on a billed-to-customer basis.

Gas Energy Efficiency Standards

In 2010, the ACC approved new Gas EE Standards which are designed to require UNS Gas and other affected utilities to implement cost-effective DSM programs. In 2011, the Gas EE Standards targeted total retail therm savings equal to 0.5% of 2010 sales; UNS Gas estimates its total savings in 2011 were 0.2%. Targeted savings increase annually in subsequent years until they reach a cumulative annual reduction in retail therm sales of 6% by 2020.

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

In April 2011, UNS Gas filed its 2011-2012 Gas Energy Efficiency implementation plan and subsequently filed an update in September 2011 which requested a waiver of the Gas EE Standards. In April 2012, UNS Gas filed a request to amend its plan to include its 2013 Energy Efficiency plan and for a modified waiver of the Gas EE Standards. We cannot predict when the ACC will rule on the Energy Efficiency plan or the subsequent requests.

Fair Value Measurements

UNS Gas' income statement exposure to risk is mitigated as UNS Gas reports the change in fair value of energy contract derivatives as a regulatory asset or a regulatory liability rather than in the income statement. See Note 9.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity Outlook

UNS Gas expects operating cash flows to fund all of its construction expenditures during 2012. 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 in future periods. Sources of funding future capital expenditures could include existing cash balances, draws on the UNS Gas/UNS Electric Revolver, additional credit lines, the issuance of long-term debt, or capital contributions from UNS Energy.

Table of Contents**Cash Flows and Capital Expenditures****Cash Flows**

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

| Nine Months Ended September 30, | 2012 | 2011 |
|--|-----------------------|--------------|
| | -Millions of Dollars- | |
| Cash Provided By (Used In): | | |
| Operating Activities | \$ 22 | \$ 22 |
| Investing Activities | (11) | (9) |
| Financing Activities | (20) | (10) |
| Net Increase/(Decrease) in Cash | (9) | 3 |
| Beginning Cash | 38 | 29 |
| Ending Cash | \$ 29 | \$ 32 |

Investing Activities

UNS Gas incurred capital expenditures of \$12 million in the first nine months of 2012 compared with \$10 million during the same period in 2011. Total capital expenditures for 2012 are estimated to be \$14 million.

Financing Activities

Cash used for financing activities at UNS Gas was \$10 million higher in the first nine months of 2012 when compared with the same period in 2011 due to an increase of \$10 million in dividends paid to UNS Energy.

UNS Gas/UNS Electric Revolver

The UNS Gas/UNS Electric Revolver consists of a \$100 million unsecured revolving credit and revolving letter of credit facility. Either company can borrow up to a maximum of \$70 million as long as the combined amount borrowed does not exceed \$100 million. The UNS Gas/UNS Electric Revolver expires November 2016.

UNS Gas is only liable for UNS Gas borrowings, and similarly, UNS Electric is only liable for UNS Electric borrowings under the UNS Gas/UNS Electric Revolver. As of September 30, 2012, UNS Gas had no outstanding borrowings or LOCs under the UNS Gas/UNS Electric Revolver.

The UNS Gas/UNS Electric Revolver restricts additional indebtedness, liens, and mergers. It also requires each borrower not to exceed a maximum leverage ratio. Each borrower may pay dividends so long as it maintains compliance with the agreement. As of September 30, 2012, UNS Gas and UNS Electric each were in compliance with the terms of the UNS Gas/UNS Electric Revolver.

Interest Rate Risk

UNS Gas is subject to interest rate risk resulting from changes in interest rates on its borrowings under its revolving credit facility. The interest paid on revolving credit borrowings is variable. If LIBOR or other benchmark interest rates increase, UNS Gas may 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*, below.

Contractual Obligations

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In 2012, UNS Gas entered into new forward fuel commitments that settle through July 2015 at fixed prices per MMBtu. UNS Gas' minimum payment obligations for these purchases are \$2 million in 2013, \$4 million in 2014, and \$2 million in 2015. There have been no other significant changes in UNS Gas' contractual obligations or other commercial commitments from those reported in our 2011 Annual Report on Form 10-K.

Table of Contents**Dividends on Common Stock**

UNS Gas paid dividends to UNS Energy, through UES, of \$10 million in August 2012, \$10 million in February 2012, and \$10 million in February 2011. 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 (i) no default or event of default exists, and (ii) it could incur additional debt under the debt incurrence test. As of September 30, 2012, UNS Gas was in compliance with the terms of its note purchase agreement.

UNS ELECTRIC**RESULTS OF OPERATIONS**

UNS Electric purchased BMGS from UED for \$63 million on July 1, 2011. In accordance with the accounting rules for a transfer between two subsidiaries under common control, UNS Electric's financial results during the first nine months of 2012 and 2011 reflect the results of BMGS. The transaction did not impact UNS Energy's consolidated financial statements.

UNS Electric reported net income of \$6 million in the third quarter of 2012 compared with \$7 million in the same period last year. In the first nine months of 2012 and 2011, UNS Electric reported net income of \$14 million. Like 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:

| | Three Months | | Nine Months | |
|---|--------------------------|-------------|--------------------------|--------------|
| | Ended September 30, 2012 | 2011 | Ended September 30, 2012 | 2011 |
| | -Millions of Dollars- | | | |
| Retail Electric Revenues | \$ 51 | \$ 54 | \$ 134 | \$ 142 |
| Wholesale Electric Revenues | 8 | 13 | 23 | 28 |
| Other Revenues | | 1 | 1 | 1 |
| Total Operating Revenues | 59 | 68 | 158 | 171 |
| Purchased Energy Expense | 27 | 41 | 71 | 94 |
| Fuel Expense | 5 | 3 | 9 | 6 |
| Transmission Expense | 3 | 4 | 8 | 9 |
| Increase (Decrease) to Reflect PPFAC Recovery | (2) | (5) | 1 | (1) |
| O&M | 8 | 7 | 23 | 19 |
| Depreciation and Amortization Expense | 5 | 4 | 14 | 13 |
| Taxes Other Than Income Taxes | 1 | 1 | 4 | 3 |
| Total Other Operating Expenses | 47 | 55 | 130 | 143 |
| Operating Income | 12 | 13 | 28 | 28 |
| Interest Expense | 2 | 2 | 5 | 5 |
| Income Tax Expense | 4 | 4 | 9 | 9 |
| Net Income | \$ 6 | \$ 7 | \$ 14 | \$ 14 |

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The table below shows UNS Electric's kWh sales and revenues for the third quarters of 2012 and 2011:

| Three Months Ended September 30, | 2012 | 2011 | Increase (Decrease) Amount | Percent ⁽¹⁾ |
|--|--------------|--------------|-------------------------------|------------------------|
| - Millions of kWh - | | | | |
| Electric Retail Sales: | | | | |
| Residential | 291 | 299 | (8) | (2.8)% |
| Commercial | 172 | 173 | (1) | (0.6)% |
| Industrial | 58 | 61 | (3) | (5.4)% |
| Mining | 20 | 50 | (30) | (60.1)% |
| Public Authorities | | | | 16.4% |
| Total Electric Retail Sales | 541 | 583 | (42) | (7.3)% |
| -Millions of Dollars- | | | | |
| Retail Margin Revenues: | | | | |
| Residential | \$ 11 | \$ 11 | \$ | (1.8)% |
| Commercial | 8 | 8 | | |
| Industrial | 2 | 2 | | |
| Mining | 2 | 2 | | (5.9)% |
| Public Authorities | | | | |
| Total Retail Margin Revenues (Non-GAAP)⁽²⁾ | 23 | 23 | | (1.3)% |
| Fuel and Purchased Power Revenues | 25 | 29 | (4) | (15.7)% |
| RES & DSM Revenues | 3 | 2 | 1 | 68.8% |
| Total Retail Revenues (GAAP) | \$ 51 | \$ 54 | \$ (3) | (7.2)% |
| Weather Data: | | | | |
| Cooling Degree Days | | | | |
| Three Months Ended September 30, | 5,446 | 5,766 | (320) | (5.5)% |
| 10-Year Average | 5,473 | 5,469 | NM | NM |

(1) Percent change calculated on unrounded data and may not correspond exactly to data shown in table.

(2) Total Retail Margin Revenues, a non-GAAP financial measure, should not be considered as an alternative to Total Retail Revenues, which is determined in accordance with GAAP. Total Retail Margin Revenues exclude revenues collected from retail customers that are directly offset by expenses recorded in other line items. We believe the change in Total Retail Margin Revenues between periods provides useful information to investors because it demonstrates the underlying revenue trend and performance of our core utility business. Total Retail Margin Revenues represents the portion of retail operating revenues available to cover the non-fuel operating expenses of our core utility business.

Total retail kWh sales in the third quarter of 2012 decreased by 7.3% compared with the same period last year. Sales volumes to mining customers decreased by 60.1% in the third quarter of 2012 due to one of UNS Electric's mining customers generating a portion of its own electricity. Total Retail Margin Revenues in the third quarter of 2012 were similar to the third quarter of 2011 level. See *Factors Affecting Results of Operations, Mining Customer*, below.

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The table below shows UNS Electric's kWh sales and revenues for the first nine months of 2012 and 2011:

| Nine Months Ended September 30, | 2012 | 2011 | Increase (Decrease) | |
|--|---------------|---------------|---------------------|------------------------|
| | | | Amount | Percent ⁽¹⁾ |
| - Millions of kWh - | | | | |
| Electric Retail Sales: | | | | |
| Residential | 666 | 652 | 14 | 2.1% |
| Commercial | 470 | 463 | 7 | 1.6% |
| Industrial | 167 | 168 | (1) | (0.5)% |
| Mining | 75 | 172 | (97) | (56.5)% |
| Public Authorities | 1 | 1 | | 1.4% |
| Total Electric Retail Sales | 1,379 | 1,456 | (77) | (5.3)% |
| -Millions of Dollars- | | | | |
| Retail Margin Revenues: | | | | |
| Residential | \$ 25 | \$ 24 | \$ 1 | 4.5% |
| Commercial | 22 | 22 | | (0.9)% |
| Industrial | 7 | 7 | | 1.5% |
| Mining | 5 | 5 | | 2.0% |
| Public Authorities | | | | |
| Total Retail Margin Revenues (Non-GAAP)⁽²⁾ | 59 | 58 | 1 | 1.9% |
| Fuel and Purchased Power Revenues | 67 | 80 | (13) | (16.2)% |
| RES & DSM Revenues | 8 | 4 | 4 | 84.4% |
| Total Retail Revenues (GAAP) | \$ 134 | \$ 142 | \$ (8) | (5.6)% |
| Weather Data: | | | | |
| Cooling Degree Days | | | | |
| Nine Months Ended September 30, | 2012 | 2011 | | |
| | 8,992 | 8,513 | 479 | 5.6% |
| 10-Year Average | 8,466 | 8,434 | NM | NM |

(1) Percent change calculated on unrounded data and may not correspond exactly to data shown in table.

(2) Total Retail Margin Revenues, a non-GAAP financial measure, should not be considered as an alternative to Total Retail Revenues, which is determined in accordance with GAAP. Total Retail Margin Revenues exclude revenues collected from retail customers that are directly offset by expenses recorded in other line items. We believe the change in Total Retail Margin Revenues between periods provides useful information to investors because it demonstrates the underlying revenue trend and performance of our core utility business. Total Retail Margin Revenues represents the portion of retail operating revenues available to cover the non-fuel operating expenses of our core utility business.

FACTORS AFFECTING RESULTS OF OPERATIONS**2012 UNS Electric Rate Filing**

In October 2012, UNS Electric filed a notice with the ACC indicating that it intends to file a rate case application by the end of 2012. The last rate order for UNS Electric, which approved an increase in non-fuel base rates in 2010, included a requirement that UNS Electric file a rate application with the ACC by July 1, 2012. That deadline was subsequently extended to December 31, 2012.

Renewable Energy Standard and Tariff

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As part of the 2010 UNS Electric rate order, the ACC authorized UNS Electric to recover operating costs, depreciation, property taxes, and a return on its investment in company-owned solar projects through RES funds until these costs are reflected in its Base Rates. Under these terms, UNS Electric expects to invest \$5 million annually in 2012 through 2014 in solar photovoltaic projects.

In July 2012, UNS Electric filed its 2013 RES implementation plan. UNS Electric's plan proposes to collect approximately \$9 million from customers during 2013, a portion of which is expected to provide recovery of operating costs and a return on investment to UNS Electric for company-owned solar projects. UNS Electric cannot predict if or when the ACC will approve its plan.

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Electric Energy Efficiency Standards

In 2010, the ACC approved Electric EE Standards. See *Tucson Electric Power, Factors Affecting Results of Operations, Electric Energy Efficiency Standards*, above for more information.

In January 2012, the ACC approved UNS Electric's 2012 Energy Efficiency implementation plan. UNS Electric's plan includes an annual performance incentive of less than \$1 million. In 2011, UNS Electric's programs saved energy equal to approximately 0.76% of its 2010 retail kWh sales. In 2012, the Electric EE Standards target a total cumulative kWh savings of 3% of 2011 retail kWh sales.

Retail Electric Competition Rules

See *Tucson Electric Power, Factors Affecting Results of Operations, Retail Electric Competition Rules*, above.

Competition

New technological developments and the implementation of the Electric EE Standards may reduce energy consumption by UNS Electric's retail customers. In addition, UNS Electric customers have the ability to install renewable energy technologies and conventional generation units that could reduce their reliance on UNS Electric's service. To date, self-generation by UNS Electric customers has not had a significant impact on retail margin revenues.

Mining Customer

UNS Electric's largest customer, a copper mine located near Kingman, Arizona, began generating a portion of its own electricity in 2011. In 2012, UNS Electric expects its mining kWh sales to decrease by approximately 50% compared with 2011. However, due to UNS Electric's Retail Rate structure, and the customer's recent peak demands, UNS Electric expects the margin revenues from this customer to be near the same level in 2012 as they were in 2011. In the first nine months of 2012 and 2011, UNS Electric's mining-related margin revenues were \$5 million in both periods.

Interest Rates

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 or other benchmark interest rates increase, UNS Electric may be required to pay higher rates of interest on borrowings under its revolving credit facility.

Fair Value Measurements

UNS Electric's income statement exposure to risk is mitigated as UNS Electric reports the change in fair value of energy contract derivatives as a regulatory asset or a regulatory liability rather than in the income statement. See Note 9.

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

UNS Electric expects operating cash flows to fund most of its construction expenditures during 2012. Additional sources of funding capital expenditures, if needed, could include draws on the UNS Gas/UNS Electric Revolver, additional credit lines, the issuance of long-term debt, or capital contributions from UNS Energy.

Cash Flows and Capital Expenditures**Cash Flows**

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

| Nine Months Ended September 30, | 2012 | 2011 |
|---------------------------------|-----------------------|-------|
| | -Millions of Dollars- | |
| Cash Provided By (Used In): | | |
| Operating Activities | \$ 39 | \$ 36 |
| Investing Activities | (22) | (85) |
| Financing Activities | (10) | 44 |
| Net Increase/(Decrease) in Cash | 7 | (5) |
| Beginning Cash | 5 | 11 |
| Ending Cash | \$ 12 | \$ 6 |

Operating Activities

Cash provided by operating activities increased by \$3 million in the first nine months of 2012 compared with the same period in 2011 due to:

a \$5 million increase in cash receipts from electric sales (net of fuel and purchased energy costs paid); and

a \$1 million decrease in income taxes paid;
partially offset by

a \$3 million increase in the payment of other operations and maintenance costs.

Investing Activities

UNS Electric had capital expenditures of \$24 million in the first nine months of 2012 compared with \$88 million in the same period in 2011. The \$88 million of capital expenditures in the first nine months of 2011 included \$63 million related to the acquisition of BMGS from UED. UNS Electric estimates total capital expenditures in 2012 of \$40 million.

Financing Activities

Cash provided by financing activities at UNS Electric in the first nine months of 2012 decreased by \$54 million when compared with the same period in 2011. Financing activities in 2012 included \$10 million in dividends paid to UNS Energy. Financing activities in 2011 included the following items related to the acquisition of BMGS: the issuance of \$30 million of long-term debt; a \$20 million equity investment from UNS

Energy; and \$6 million distribution to UED.

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.

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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 LOCs to provide credit enhancement for its energy procurement and hedging activities. As of September 30, 2012, UNS Electric had no outstanding borrowings and \$1 million of LOCs issued under the UNS Gas/UNS Electric Revolver.

Contractual Obligations

In 2012, UNS Electric entered into new forward purchase power commitments that will settle through December 2014. Some of these contracts are at fixed prices per MWh and others are indexed to natural gas prices. Based on projected market prices as of September 30, 2012, UNS Electric's estimated minimum payment obligations for these purchases are \$2 million in 2013 and \$8 million in 2014. There have been no other significant changes in UNS Electric's contractual obligations or other commercial commitments from those reported in our 2011 Annual Report on Form 10-K.

Dividends on Common Stock

UNS Electric paid dividends to UNS Energy, through UES, of \$10 million in August 2012. UNS Electric's ability to pay future 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 (i) no default or event of default exists, and (ii) it could incur additional debt under the debt incurrence test. As of September 30, 2012, UNS Electric was in compliance with the terms of its note purchase agreement and the terms of the UNS Gas/UNS Electric Revolver.

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

The table below summarizes the net loss for the other non-reportable segments:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------------|---|-------------|--|-------------|
| | 2012 | 2011 | 2012 | 2011 |
| | -Millions of Dollars- | | -Millions of Dollars- | |
| Millennium | \$ | \$ 1 | \$ 2 | \$ 2 |
| Other ⁽¹⁾ | | (1) | (3) | (4) |
| Total Other Net Loss | \$ | \$ | \$ (1) | \$ (2) |

⁽¹⁾ Includes parent company expenses, UED, and reconciling adjustments.

UNS Energy Parent Company

UNS Energy parent company expenses primarily include interest expense (net of tax) related to the Convertible Senior Notes and the UNS Credit Agreement. All of the Convertible Senior Notes were either converted to common stock or redeemed for cash during the first six months of 2012. See *UNS Energy, Liquidity and Capital Resources, Convertible Senior Notes*, for more information.

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FACTORS AFFECTING RESULTS OF OPERATIONS

Millennium Investments

At September 30, 2012, Millennium had assets of \$8 million including a \$3 million note receivable due October 2012 and a cash balance of \$4 million. The note receivable was paid in full in October 2012. In the third quarter of 2012, Millennium paid \$14 million of dividends to UNS Energy.

Note Receivable

In 2009, Millennium sold an equity investment and recorded a \$6 million gain on the sale. Millennium received an upfront payment of \$5 million in 2009 and a \$15 million, three-year, 6% secured promissory note with a maturity date of June 2012. In June 2012, at the request of the borrower, Millennium agreed to change the payment provisions and maturity date of the note. The remaining terms of the note, including provisions securing the payment of the loan amount, remained unchanged. Under the modified payment terms, Millennium received the principal amount of \$15 million in monthly payments between June and October 2012, as well as a \$0.25 million amendment fee in June 2012. The note, including accrued interest, was fully repaid in October 2012. See Note 11.

CRITICAL ACCOUNTING ESTIMATES

There have been no significant changes in our accounting policies from those disclosed in our 2011 Annual Report on Form 10-K.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board issued authoritative guidance which amends the guidance for impairment testing of indefinite-lived intangible assets. An entity will have the option to perform qualitative analysis to determine whether an indefinite-lived intangible asset may be impaired. If the qualitative assessment does not result in likely impairment, an entity will not be required to perform the quantitative impairment test. We will be required to comply in the first quarter of 2013; however we do not expect this pronouncement to have a material impact on our financial statements as our indefinite-lived intangible assets, Renewable Energy Credits (RECs), which are currently recoverable under the Renewable Energy Standard as we use the RECs to comply with the standard's renewable resources requirements.

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. UNS 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 UNS 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 UNS Energy or TEP, are expressly qualified by these cautionary statements and any other cautionary statements which may accompany the forward-looking statements. In addition, UNS 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 therein. We express our expectations, beliefs, and projections in good faith and believe them to have a reasonable basis. However, we make no assurances that management's expectations, beliefs or projections will be achieved or accomplished. We have identified the following important factors that could cause actual results to differ materially from those discussed in our forward-looking statements. These may be in addition to other factors and matters discussed in: *Part II, Item 1A. Risk Factors; Part I, Item 2. Management's Discussion and Analysis*; and other parts of this report. These factors include: state and federal regulatory and legislative decisions and actions; 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 our 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; cyber attacks or challenges to our information security; and the performance of TEP's generating plants.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

UNS Energy's and TEP's primary market risks include fluctuations in interest rates, commodity prices and volumes, and counterparty credit. Fluctuations in interest rates can affect earnings and cash flows. We enter into interest rate swaps and financing transactions to manage changes in interest rates. Fluctuations in commodity prices and volumes and counterparty credit losses may temporarily affect cash flows, but are not expected to affect earnings due to expected recovery through regulatory mechanisms.

There have been no additional risks and no material changes to market risks disclosed in *Part II, Item 7A* in our Annual Report on Form 10-K for the year ended December 31, 2011, other than the following:

Commodity Price Risk TEP

See Item 2. Management's Discussion and Analysis, Tucson Electric Power, Factors Affecting Results of Operations, Long-Term Wholesale Sales, Salt River Project.

ITEM 4. CONTROLS AND PROCEDURES

UNS Energy's and TEP's Chief Executive Officer and Chief Financial Officer supervised and participated in UNS Energy's 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 UNS Energy's 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 UNS 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, UNS Energy's and TEP's Chief Executive Officer and Chief Financial Officer concluded that UNS Energy's and TEP's disclosure controls and procedures are effective.

While UNS 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 UNS Energy's or TEP's internal control over financial reporting during the third quarter of 2012 that has materially affected, or is reasonably likely to materially affect, UNS Energy's or TEP's internal control over financial reporting.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See the legal proceedings described in *Item 3. Legal Proceedings* in our 2011 Annual Report on Form 10-K and in Note 6 and in *Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations*, which descriptions in Note 6 and Item 2 are incorporated herein by reference.

Springerville Unit 1 is leased by TEP under leases which expire in 2015 and which provide TEP with an option to purchase the lease interests upon the lease expiration at fair market value. In December 2011, TEP and the owner participants of the Springerville Unit 1 Leases completed a formal appraisal procedure with three appraisers in accordance with the lease agreements to determine the fair market value purchase price. The lease agreements provide that the purchase price determined through the appraisal procedure will be final and binding upon the parties. The aggregate purchase price for the owner participants' lease interests was determined to be \$159 million.

On April 26, 2012, TEP filed a petition to confirm the appraisal in the United States District Court for the District of Arizona naming the owner participants (Daimler Capital Services LLC, LDVFI TEP LLC, Alterna Springerville LLC, MWR Capital Inc. and Pacific Harbor Capital Inc.) and the owner trustee and co-trustee (Wilmington Trust Company and William J. Wade) as respondents. The petition states that TEP filed the petition since neither the owner participants nor the owner trustee and co-trustee have acknowledged that the purchase price determined by the appraisal procedure in December 2011 is final and binding and that TEP seeks an order from the court confirming the appraisal as an arbitration award under the Federal Arbitration Act.

On June 1, 2012, the owner participants filed a response in opposition to TEP's petition. In their response, the owner participants allege that the appraisal procedure failed to yield a legitimate purchase price for the lease interests, stating, among other things, that not all of the three appraisers performed their appraisals in accordance with required standards. The owner participants request that the court dismiss the action and deny TEP's petition on the grounds that there is not a present controversy for the court to decide, since, among other things, TEP has not exercised the purchase option. The owner participants also dispute TEP's position that the appraisal procedure should be treated as an arbitration award for purposes of judicial review.

Oral argument was heard in the matter in July 2012 and TEP is currently awaiting the Court's decision.

TEP believes that the appraisal procedure was properly conducted in accordance with the lease agreements and that the results are final and binding. TEP intends to vigorously pursue its legal remedies to confirm the results of the appraisal procedure.

ITEM 1A. RISK FACTORS

The business and financial results of UNS Energy and TEP are subject to numerous risks and uncertainties. There are no significant changes to the risks and uncertainties reported in our 2011 Annual Report on Form 10-K and Quarterly Report on Form 10-Q for the quarter ended June 30, 2012.

ITEM 2. UNREGISTERED SALE OF EQUITY SECURITIES AND USE OF PROCEEDS

See *Part I, Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations, UNS Energy Consolidated, Liquidity and Capital Resources, Convertible Senior Notes.*

Table of Contents**ITEM 5. OTHER INFORMATION****COMPREHENSIVE INCOME**

The Financial Accounting Standards Board issued authoritative guidance that eliminated the option to report other comprehensive income in the statement of changes in equity. Rather, an entity must elect to present items of net income and other comprehensive income in one continuous statement or in two separate but consecutive statements. Effective in the first quarter of 2012, we elected to include separate statements of comprehensive income (loss) with our financial statements.

UNS Energy's and TEP's comprehensive income for the previous three years are presented below:

| | UNS Energy | | |
|--|---------------------------------|-------------------|-------------------|
| | Years Ended December 31, | | |
| | 2011 | 2010 | 2009 |
| | -Thousands of Dollars- | | |
| Comprehensive Income | | | |
| Net Income | \$ 109,975 | \$ 112,984 | \$ 105,901 |
| Other Comprehensive Income (Loss) | | | |
| Unrealized Gain (Loss) on Cash Flow Hedges, net of \$2,376; \$4,216; and \$(33) income taxes | (3,626) | (6,431) | 51 |
| Reclassification of Realized Losses on Cash Flow Hedges to Net Income, net of \$(1,412); \$(2,140); and \$(690) income taxes | 2,153 | 3,264 | 1,053 |
| Supplemental Executive Retirement Plan Benefit Adjustments, net of \$(804); \$523; and \$33 income taxes | 1,158 | (800) | (51) |
| Total Other Comprehensive Income (Loss), Net of Income Taxes | (315) | (3,967) | 1,053 |
| Total Comprehensive Income | \$ 109,660 | \$ 109,017 | \$ 106,954 |

| | TEP | | |
|--|---------------------------------|-------------------|------------------|
| | Years Ended December 31, | | |
| | 2011 | 2010 | 2009 |
| | -Thousands of Dollars- | | |
| Comprehensive Income | | | |
| Net Income | \$ 85,334 | \$ 108,260 | \$ 90,688 |
| Other Comprehensive Income (Loss) | | | |
| Unrealized Gain (Loss) on Cash Flow Hedges, net of \$2,331; \$4,216; and \$(33) income taxes | (3,555) | (6,431) | 51 |
| Reclassification of Realized Losses on Cash Flow Hedges to Net Income, net of \$(1,390); \$(2,140); and \$(690) income taxes | 2,122 | 3,264 | 1,053 |
| Supplemental Executive Retirement Plan Benefit Adjustments, net of \$(804); \$523; and \$33 income taxes | 1,158 | (800) | (51) |
| Total Other Comprehensive Income (Loss), Net of Income Taxes | (275) | (3,967) | 1,053 |
| Total Comprehensive Income | \$ 85,059 | \$ 104,293 | \$ 91,741 |

Table of Contents**RATIO OF EARNINGS TO FIXED CHARGES**

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

| | Nine Months Ended September 30, 2012 | Twelve Months Ended September 30, 2012 |
|------------|---|---|
| UNS Energy | 2.614 | 2.283 |
| TEP | 2.495 | 2.113 |

For purposes of this computation, earnings are defined as pre-tax earnings plus interest expense and amortization of debt discount and expense on indebtedness. Fixed charges are interest expense, including amortization of debt discount and expense on indebtedness.

ENVIRONMENTAL MATTERS**Clean Air Act Requirements**

The Environmental Protection Agency (EPA) limits the amount of sulfur dioxide (SO₂), nitrogen oxide (NO_x), particulate matter, mercury and other emissions released into the atmosphere by power plants. TEP may incur added costs to comply with future changes in federal and state environmental laws, regulations, and permit requirements at its power plants. Complying with these changes may reduce operating efficiency. TEP expects to recover the cost of environmental compliance from its ratepayers.

TEP has sufficient emission allowances to comply with acid rain SO₂ regulations.

Hazardous Air Pollutant Requirements

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

Navajo Generating Station

Based on the EPA's final standards, Navajo Generating Station (Navajo) may need mercury and particulate matter emission control equipment by 2015. TEP's share of the estimated capital cost of this equipment is less than \$1 million for mercury control and about \$43 million if the installation of baghouses to control particulates is necessary. TEP expects its share of the annual operating costs for mercury control and baghouses to be less than \$1 million each. The operator of Navajo is currently analyzing the need for baghouses under various regulatory scenarios, which will be affected by final Best Available Retrofit Technology (BART) rules when issued.

San Juan Generating Station

TEP expects San Juan Generating Station's (San Juan) current emission controls to be adequate to comply with the EPA's final standards.

Four Corners Generating Station

Based on the EPA's final standards, Four Corners Generating Station (Four Corners) may need mercury emission control equipment by 2015. The estimated capital cost of this equipment is less than \$1 million. We expect the annual operating cost of the mercury emission control equipment to be less than \$1 million.

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Springerville Generating Station

Based on the EPA's final standards, Springerville Generating Station (Springerville) may need mercury emission control equipment by 2015. The estimated capital cost of this equipment for Springerville Units 1 and 2 is about \$5 million. TEP expects the annual operating cost of the mercury emission control equipment to be about \$3 million.

Sundt Generating Station

TEP expects the final EPA standards will have little effect on capital expenditures at Sundt Generating Station (Sundt).

Climate Change

In 2007, the Supreme Court ruled in *Commonwealth of Massachusetts, et al. v. EPA* that carbon dioxide and other Green House Gases (GHG) are air pollutants under the Clean Air Act. In 2009, the EPA issued a final Endangerment Finding stating that GHGs endanger public health and welfare. The EPA issued final GHG regulations for new motor vehicles in 2010 triggering GHG permitting requirements for power plants under the Clean Air Act. As of January 2011, air quality permits for new sources and modifications of existing sources must include an analysis for GHG controls. In the near term, based on our current construction plans, we do not expect the new permitting requirements to impact TEP or UNS Electric.

In March 2012, the EPA released its proposed new source performance standard for GHGs. TEP does not anticipate this standard will have any material impact on its existing facilities.

In 2010, New Mexico adopted regulations limiting GHG emissions from power plants. Several parties filed petitions to repeal those regulations and the New Mexico Environmental Improvement Board held hearings on the repeal petitions in November and December 2011. In the first quarter of 2012, the New Mexico Environmental Improvement Board repealed all of the 2010 GHG regulations.

Based on the competing proposals to regulate GHG emissions by federal, state, and local regulatory and legislative bodies and uncertainty in the regulatory and legislative processes, the scope of such requirements and initiatives and their effect on our operations cannot be determined at this time.

Regional Haze 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. States must submit these goals and strategies to the EPA for approval. Because Navajo and Four Corners are located on the Navajo Indian Reservation, they are not subject to state oversight. The EPA oversees regional haze planning for these power plants.

Complying with the EPA's BART findings, and with other future environmental rules, may make it economically impractical to continue operating the Navajo, San Juan, and Four Corners power plants or for individual owners to continue to participate in these power plants. TEP cannot predict the ultimate outcome of these matters.

Navajo

TEP expects the EPA to issue a final rule establishing the BART for Navajo later in 2012. If the EPA decides that Selective Catalytic Reduction (SCR) technology is required at Navajo, TEP estimates its share of the capital cost will be \$42 million. Also, the installation of SCR technology at Navajo could increase the generating facility's particulate emissions which may require that baghouses be installed. TEP estimates that its share of the capital expenditure for baghouses would be about \$43 million. Until the EPA issues a final ruling, pollution control costs will not be known. If the EPA finalizes a BART rule for Navajo that requires SCR technology, TEP expects the owners to have five years to comply.

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San Juan

In August 2011, the EPA issued a Federal Implementation Plan (FIP) establishing new emission limits for air pollutants at San Juan. These requirements are more stringent than those proposed by the State of New Mexico. The FIP requires the installation of SCR technology with sorbent injection on all four units within five years to reduce NOx and control sulfuric acid emissions by September 2016. PNM operates San Juan and TEP owns 50% of San Juan Units 1 and 2, or 340 MW of capacity. TEP estimates its share of the cost to install SCR technology with sorbent injection to be between \$180 million and \$200 million.

In 2011, PNM filed a petition for review of and a motion to stay the FIP with the Tenth Circuit United States Court of Appeals (Circuit Court). In addition, PNM filed a request for reconsideration of the rule with the EPA and a request to stay the effectiveness of the rule pending the EPA's reconsideration and the review by the Circuit Court. The State of New Mexico filed similar motions with the Circuit Court and the EPA. In March 2012, the Circuit Court denied PNM's and the State of New Mexico's motion for stay. In July 2012, the EPA issued a 90-day stay to allow the State of New Mexico, the EPA, PNM, and other interested parties to evaluate alternatives to the final FIP.

Several environmental groups were granted permission to join in opposition to PNM's petition to review in the Circuit Court. In addition, WildEarth Guardians filed a separate appeal against the EPA challenging the FIP's five-year implementation schedule. PNM was granted permission to join in opposition to that appeal. In April 2012, PNM, the State of New Mexico, and WildEarth Guardians individually filed briefs on the merits in their respective Circuit Court appeals. Oral argument on the appeals was heard in October 2012.

In October 2012, the State of New Mexico released a proposed settlement agreement that it presented to the EPA as an alternative to the FIP. The proposed settlement includes: the retirement of San Juan Units 1 and 2 by December 31, 2017 and the replacement of those units with non-coal generation sources; and the installation of selective non-catalytic reduction technology on San Juan Units 3 and 4. Also in October 2012, the EPA extended the 90-day stay until November 29, 2012, to allow for further discussions on the proposed settlement agreement.

If San Juan Units 1 and 2 are retired by December 31, 2017, TEP expects to request ACC approval to recover, over a reasonable time period, all costs associated with the early retirement of those units. At September 30, 2012, the book value of TEP's share of San Juan Units 1 and 2 was \$216 million. We are evaluating various replacement resources in the event San Juan Units 1 and 2 are retired early, including the possibility of exchanging part of TEP's ownership in San Juan Units 1 and 2 for a portion of San Juan Units 3 and/or 4. Any decision regarding early closure and replacement resources will require various actions by third parties as well as UNS Energy board and regulatory approvals.

If the FIP compliance date is not extended or the decision to close San Juan 1 and 2 is not made by the end of 2012, TEP may begin funding its share of the capital expenditures to install SCR technology as required under the FIP in 2013.

TEP cannot predict the ultimate outcome of this matter.

Four Corners

In August 2012, the EPA finalized the regional haze FIP for Four Corners. The final FIP requires SCR technology to be installed on all five units by 2017. However, the FIP also includes an alternative plan that allows Arizona Public Service Company to close their wholly owned Units 1, 2, and 3, and install SCR technology on Units 4 and 5. This option allows the installation of SCR technology to be delayed until July 2018. In either case, TEP's estimated share of the capital costs to install SCR technology is about \$35 million.

Springerville

Regional haze regulations requiring emission control upgrades do not apply to Springerville currently and are not likely to impact Springerville operations until after 2018.

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Sundt

The EPA is required to issue a proposal regarding unaddressed state regional haze compliance issues in December 2012. The proposal may, among other things, include a determination regarding whether Sundt Unit 4 could be regulated under certain regional haze provisions.

Coal Combustion Residuals

In 2010, the EPA proposed a rule to regulate the handling and disposal of coal ash and other Coal Combustion Residuals (CCRs). The EPA has proposed regulating CCRs as either non-hazardous solid waste or hazardous waste. The hazardous waste alternative would require additional capital investments and operational costs for both storage and handling at plants and transportation to disposal locations. Both the hazardous waste and non-hazardous solid waste alternatives would require liners for new ash landfills or expansions to existing ash landfills. The rules will apply to CCRs produced by all of TEP's coal-fired generating assets. San Juan may also be subject to separate regulations being drafted by the Office of Surface Mining Reclamation and Enforcement because it disposes of CCRs in surface mine pits.

The EPA has not yet indicated a preference for an alternative. Each option would allow CCRs to be beneficially reused or recycled as components of other products. We expect the EPA to issue a final rule by the end of 2012. TEP cannot determine the financial impact of this rulemaking at this time.

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.

UNS ENERGY CORPORATION
(Registrant)

Date: November 2, 2012

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

TUCSON ELECTRIC POWER COMPANY
(Registrant)

Date: November 2, 2012

/s/ 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 | UNS Energy. |
| 12(b) | Computation of Ratio of Earnings to Fixed Charges | TEP. |
| 15(a) | Letter regarding unaudited interim financial information | UNS Energy. |
| 15(b) | Letter regarding unaudited interim financial information | TEP. |
| 31(a) | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act | UNS Energy, by Paul J. Bonavia. |
| 31(b) | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act | UNS 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(a) | Statements of Corporate Officers (pursuant to Section 906 of the Sarbanes-Oxley Act of 2002) | UNS Energy. |
| **32(b) | Statements of Corporate Officers (pursuant to Section 906 of the Sarbanes-Oxley Act of 2002) | TEP. |
| ***101 | The following materials from UNS Energy Corporation's and Tucson Electric Power Company's Quarterly Report on Form 10-Q for the three and nine-month periods ended September 30, 2012, formatted in XBRL (Extensible Business Reporting Language): | |
| | (a) | UNS Energy Corporation's and Tucson Electric Power Company's (i) Condensed Consolidated Statements of Income (ii) Condensed Consolidated Statements of Comprehensive Income (iii) Condensed Consolidated Statements of Cash Flows, (iv) Condensed Consolidated Balance Sheets, (v) Condensed Consolidated Statement of Changes in Stockholders' Equity; and |
| | (b) | Notes to Condensed Consolidated Financial Statements. |

** Not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

*** XBRL materials for Tucson Electric Power Company are deemed not filed or part of a registration statement or prospectus for the purposes of Section 11 or 12 of the Securities Act of 1933, as amended, and are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under these sections.