TUCSON ELECTRIC POWER CO
Form 10-Q
May 01, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2018
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to .
Commission File Number 1-5924
TUCSON ELECTRIC POWER COMPANY
(Exact name of registrant as specified in its charter)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):
Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer x Smaller Reporting Company o Emerging Growth Company o
If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x
All shares of outstanding common stock of Tucson Electric Power Company are held by its parent company, UNS Energy Corporation, which is an indirect, wholly-owned subsidiary of Fortis Inc. There were 32,139,434 shares of common stock, no par value, outstanding as of April 30, 2018.

i

Table of Contents

DEFINITIONS

The abbreviations and acronyms used in the first three months of 2018 Form 10-Q are defined below:

2010 Reimbursement Agreement	Reimbursement Agreement, dated December 14, 2010, between TEP, as borrower, and a financial institution
2017 Rate Order	A rate order issued by the ACC resulting in a new rate structure for TEP, effective on February 27, 2017
ACC	Arizona Corporation Commission
ACC Refund Order	An order issued by the ACC approving TEP’s proposal to return ongoing savings from the Company’s federal corporate income tax rate under the Tax Cuts and Jobs Act to its customers through a combination of a customer bill credit and a regulatory liability that reflects the deferral of the return of a portion of the savings
ASU	Accounting Standard Update
BART	Best Available Retrofit Technology
BBtu	Billion British thermal units
DG	Distributed Generation
DSM	Demand Side Management
EDIT	Excess Deferred Income Taxes
EE Standards	Energy Efficiency Standards
EPA	Environmental Protection Agency
FERC	Federal Energy Regulatory Commission
Fortis	Fortis Inc., a corporation incorporated under the Corporations Act of Newfoundland and Labrador, Canada, whose principal executive offices are located at Fortis Place, Suite 1100, 5 Springdale Street, St. John's, NL A1E 0E4
Four Corners	Four Corners Generating Station
GAAP	Generally Accepted Accounting Principles in the United States of America
Gila River	Gila River Generating Station
GWh	Gigawatt-hour(s)
kWh	Kilowatt-hour(s)
LFCR	Lost Fixed Cost Recovery
LOC	Letter(s) of Credit
Luna	Luna Generating Station
MW	Megawatt(s)
MWh	Megawatt-hour(s)
Navajo	Navajo Generating Station
NBV	Net Book Value
Phase 2	Second phase of TEP's rate case proceedings originally filed November 2015
PPA	Power Purchase Agreement
PPFAC	Purchased Power and Fuel Adjustment Clause
Regional Haze Rules	Rules promulgated by the EPA to improve visibility at national parks and wilderness areas
RES	Renewable Energy Standard
Retail Rates	Rates designed to allow a regulated utility recovery of its costs of providing services and an opportunity to earn a reasonable return on its investment
San Juan	San Juan Generating Station
SCR	Selective Catalytic Reduction
SES	Southwest Energy Solutions, Inc.
SJCC	San Juan Coal Company
SNCR	Selective Non-Catalytic Reduction

Springerville	Springerville Generating Station
Sundt	H. Wilson Sundt Generating Station

TCJA	On December 22, 2017, the Tax Cuts and Jobs Act was signed into law enacting significant changes to the Internal Revenue Code including a reduction in the federal corporate income tax rate from 35% to 21% effective for tax years beginning after 2017
TEP	Tucson Electric Power Company, the principal subsidiary of UNS Energy Corporation
TSA	Transmission Service Agreement
UNS Electric	UNS Electric, Inc., an indirect wholly-owned subsidiary of UNS Energy Corporation
UNS Energy	UNS Energy Corporation, the parent company of TEP, whose principal executive offices are located at 88 East Broadway Boulevard, Tucson, Arizona 85701
UNS Energy Affiliates	Affiliated subsidiaries of UNS Energy Corporation including UniSource Energy Services, Inc., UNS Electric, Inc., UNS Gas, Inc., and Southwest Energy Solutions, Inc.
UNS Gas	UNS Gas, Inc., an indirect wholly-owned subsidiary of UNS Energy Corporation
VIE	Variable Interest Entity

Table of Contents

FORWARD-LOOKING INFORMATION

This Quarterly Report on Form 10-Q contains forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. Tucson Electric Power Company (TEP or the Company) is including the following cautionary statements to make applicable and take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 for any forward-looking statements made by TEP in this Quarterly Report on Form 10-Q. Forward-looking statements include statements concerning plans, objectives, goals, strategies, future events, future economic conditions, future operational or financial 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, believes, estimates, expects, intends, may, plans, predicts, potential, projects, would, and similar expressions. From time to time, we may publish or otherwise make available forward-looking statements of this nature. All such forward-looking statements, whether written or oral, and whether made by or on behalf of TEP, are expressly qualified by these cautionary statements and any other cautionary statements which may accompany the forward-looking statements. In addition, TEP disclaims any obligation to update any forward-looking statements to reflect events or circumstances after the date of this report, except as may otherwise be required by the federal securities laws.

Forward-looking statements involve risks and uncertainties which could cause actual results or outcomes to differ materially from those expressed therein. We express our estimates, expectations, beliefs, and projections in good faith and believe them to have a reasonable basis. However, we make no assurances that management’s estimates, expectations, beliefs, or projections will be achieved or accomplished. We have identified the following important factors that could cause actual results to differ materially from those discussed in our forward-looking statements. These may be in addition to other factors and matters discussed in: Part I, Item 1A. Risk Factors of our 2017 Form 10-K; Part II, Item 1A. Risk Factors; Part I, Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations; and other parts of this report. These factors include: state and federal regulatory and legislative decisions and actions, including changes in tax policies; changes in, and compliance with, environmental laws and regulatory decisions and policies that could increase operating and capital costs, reduce generation facility output or accelerate generation facility retirements; regional economic and market conditions which could affect customer growth and energy usage; changes in energy consumption by retail customers; weather variations affecting energy usage; the cost of debt and equity capital and access to capital markets and bank markets; the performance of the stock market and a changing interest rate environment, which affect the value of our pension and other postretirement benefit plan assets and the related contribution requirements and expenses; the potential inability to make additions to our existing high voltage transmission system; unexpected increases in operations and maintenance expense; resolution of pending litigation matters; changes in accounting standards; changes in our critical accounting policies and estimates; the ongoing impact of mandated energy efficiency and distributed generation (DG) initiatives; changes to long-term contracts; the cost of fuel and power supplies; the ability to obtain coal from our suppliers; cyber-attacks, data breaches, or other challenges to our information security, including our operations and technology systems; the performance of TEP's generation facilities; and the impact of the Tax Cuts and Jobs Act (TCJA) on our financial condition and results of operations, including the assumptions we make relating thereto.

Table of Contents

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

	Three Months Ended March 31,	
	2018	2017
Operating Revenues	$275,091	$268,382
Operating Expenses		
Fuel	68,022	66,728
Purchased Power	20,364	24,295
Transmission and Other PPFAC Recoverable Costs	9,791	8,899
Decrease to Reflect PPFAC Recovery Treatment	(7,966)	(8,190)
Total Fuel and Purchased Power	90,211	91,732
Operations and Maintenance	83,156	82,141
Depreciation	38,877	38,157
Amortization	6,022	5,402
Taxes Other Than Income Taxes	14,180	13,800
Total Operating Expenses	232,446	231,232
Operating Income	42,645	37,150
Other Income (Expense)		
Interest Expense	(16,485)	(16,315)
Allowance For Borrowed Funds	688	530
Allowance For Equity Funds	1,645	1,358
Other, Net	(425)	7,728
Total Other Income (Expense)	(14,577)	(6,699)
Income Before Income Tax Expense	28,068	30,451
Income Tax Expense	4,265	9,692
Net Income	$23,803	$20,759

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

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

	Three Months Ended March 31,	
	2018	2017
Comprehensive Income		
Net Income	$23,803	$20,759
Other Comprehensive Income		
Net Changes in Fair Value of Cash Flow Hedges:		
Net of Income Tax Expense of $41 and $74	123	119
Supplemental Executive Retirement Plan Adjustments:		
Net of Income Tax Expense of $40 and $43	115	70
Total Other Comprehensive Income, Net of Tax	238	189
Total Comprehensive Income	$24,041	$20,948

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

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

	Three Months Ended March 31,	
	2018	2017
Cash Flows from Operating Activities		
Net Income	$23,803	$20,759
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation Expense	38,877	38,157
Amortization Expense	6,022	5,402
Amortization of Debt Issuance Costs	589	589
Use of Renewable Energy Credits for Compliance	7,476	5,385
Deferred Income Taxes	5,915	9,709
Pension and Other Postretirement Benefits Expense	3,818	4,010
Pension and Other Postretirement Benefits Funding	(1,498)	(1,088)
Allowance for Equity Funds Used During Construction	(1,645)	(1,358)
Changes in Current Assets and Current Liabilities:		
Accounts Receivable	8,603	15,875
Materials, Supplies, and Fuel Inventory	8,344	1,051
Regulatory Assets	(4,601)	(6,063)
Accounts Payable and Accrued Charges	(14,938)	11,409
Regulatory Liabilities	2,470	(7,342)
Other, Net	876	1,553
Net Cash Flows—Operating Activities	84,111	98,048
Cash Flows from Investing Activities		
Capital Expenditures	(82,805)	(78,809)
Purchase Intangibles, Renewable Energy Credits	(10,106)	(11,051)
Contributions in Aid of Construction	5,467	929
Net Cash Flows—Investing Activities	(87,444)	(88,931)
Cash Flows from Financing Activities		
Proceeds from Borrowings, Revolving Credit Facility	27,000	—
Repayments of Borrowings, Revolving Credit Facility	(31,000)	—
Payments of Capital Lease Obligations	(10,930)	(10,310)
Other, Net	341	285
Net Cash Flows—Financing Activities	(14,589)	(10,025)
Net Decrease in Cash, Cash Equivalents, and Restricted Cash	(17,922)	(908)
Cash, Cash Equivalents, and Restricted Cash, Beginning of Period	49,501	43,325
Cash, Cash Equivalents, and Restricted Cash, End of Period	$31,579	$42,417

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

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)
(Amounts in thousands, except share data)

	March 31, 2018	December 31, 2017
ASSETS		
Utility Plant		
Plant in Service	$5,827,542	$5,780,805
Utility Plant Under Capital Leases	84,870	84,870
Construction Work in Progress	166,010	160,288
Total Utility Plant	6,078,422	6,025,963
Accumulated Depreciation and Amortization	(2,217,976)	(2,193,656)
Accumulated Amortization of Capital Lease Assets	(65,227)	(63,605)
Total Utility Plant, Net	3,795,219	3,768,702
Investments and Other Property	50,085	51,260
Current Assets		
Cash and Cash Equivalents	19,995	37,701
Accounts Receivable, Net	130,268	137,932
Fuel Inventory	18,026	25,059
Materials and Supplies	102,669	103,981
Regulatory Assets	109,278	93,960
Derivative Instruments	2,704	3,187
Other	13,671	10,777
Total Current Assets	396,611	412,597
Regulatory and Other Assets		
Regulatory Assets	298,098	293,551
Derivative Instruments	9,643	8,826
Other	58,018	55,313
Total Regulatory and Other Assets	365,759	357,690
Total Assets	$4,607,674	$4,590,249

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

(Continued)

4

TUCSON ELECTRIC POWER COMPANY
CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)
(Amounts in thousands, except share data)

	March 31, 2018	December 31, 2017
CAPITALIZATION AND OTHER LIABILITIES		
Capitalization		
Common Stock Equity:		
Common Stock (No Par Value, 75,000,000 Shares Authorized, 32,139,434 Shares Outstanding as of March 31, 2018 and December 31, 2017)	$1,296,539	$1,296,539
Capital Stock Expense	(6,357)	(6,357)
Retained Earnings	404,757	380,076
Accumulated Other Comprehensive Loss	(6,866)	(6,226)
Total Common Stock Equity	1,688,073	1,664,032
Preferred Stock (No Par Value, 1,000,000 Shares Authorized, None Outstanding as of March 31, 2018 and December 31, 2017)	—	—
Capital Lease Obligations	17,629	28,519
Long-Term Debt, Net	1,318,062	1,354,423
Total Capitalization	3,023,764	3,046,974
Current Liabilities		
Current Maturities of Long-Term Debt	136,700	100,000
Borrowings Under Revolving Credit Facility	31,000	35,000
Capital Lease Obligations	10,535	10,749
Accounts Payable	78,809	97,367
Accrued Taxes Other than Income Taxes	53,410	40,706
Accrued Employee Expenses	19,506	30,929
Accrued Interest	12,646	14,750
Regulatory Liabilities	92,518	89,024
Customer Deposits	25,529	24,865
Derivative Instruments	20,539	10,667
Other	18,250	18,119
Total Current Liabilities	499,442	472,176
Regulatory and Other Liabilities		
Deferred Income Taxes, Net	306,667	300,258
Regulatory Liabilities	512,318	516,438
Pension and Other Postretirement Benefits	134,484	133,799
Derivative Instruments	27,350	17,907
Other	103,649	102,697
Total Regulatory and Other Liabilities	1,084,468	1,071,099
Commitments and Contingencies		
Total Capitalization and Other Liabilities	$4,607,674	$4,590,249

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

(Concluded)

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

	Common Stock	Capital Stock Expense	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholder's Equity
Balances as of December 31, 2016	$1,296,539	$(6,357)	$273,408	$ (4,555)	$ 1,559,035
Net Income			20,759		20,759
Other Comprehensive Income, Net of Tax				189	189
Balances as of March 31, 2017	$1,296,539	$(6,357)	$294,167	$ (4,366)	$ 1,579,983

	Common Stock	Capital Stock Expense	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholder's Equity
Balances as of December 31, 2017	$1,296,539	$(6,357)	$380,076	$ (6,226)	$ 1,664,032
Net Income			23,803		23,803
Other Comprehensive Income, Net of Tax				238	238
Adoption of ASU, Cumulative Effect Adjustment			878	(878)	—
Balances as of March 31, 2018	$1,296,539	$(6,357)	$404,757	$ (6,866)	$ 1,688,073

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

6

Table of Contents
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. NATURE OF OPERATIONS AND FINANCIAL STATEMENT PRESENTATION

TEP is a regulated utility that generates, transmits, and distributes electricity to approximately 424,000 retail customers in a 1,155 square mile area in southeastern Arizona. TEP also sells electricity to other utilities and power marketing entities, located primarily in the western United States. TEP is a wholly-owned subsidiary of UNS Energy Corporation (UNS Energy), a utility services holding company. UNS Energy is an indirect wholly-owned subsidiary of Fortis Inc. (Fortis).

BASIS OF PRESENTATION

TEP's Condensed Consolidated Financial Statements and disclosures are presented in accordance with Generally Accepted Accounting Principles (GAAP) in the United States of America, including specific accounting guidance for regulated operations and the Securities and Exchange Commission's (SEC) interim reporting requirements.

The Condensed Consolidated Financial Statements include the accounts of TEP and its subsidiaries. In the consolidation process, accounts of the parent and subsidiaries are combined and intercompany balances and transactions are eliminated. TEP jointly owns several generation and transmission facilities with both affiliated and non-affiliated entities. TEP's proportionate share of jointly-owned facilities is recorded in Utility Plant on the Condensed Consolidated Balance Sheets, and its proportionate share of the operating costs associated with these facilities is included in the Condensed Consolidated Statements of Income. These Condensed Consolidated Financial Statements exclude some information and footnotes required by GAAP and the SEC for annual financial statement reporting and should be read in conjunction with the Consolidated Financial Statements and footnotes in TEP's 2017 Annual Report on Form 10-K.

The Condensed Consolidated Financial Statements are unaudited, but, in management's opinion, include all normal, recurring adjustments necessary for a fair presentation of the results for the interim periods presented. Because weather and other factors cause seasonal fluctuations in sales, TEP's quarterly operating results are not indicative of annual operating results.

Certain amounts from prior periods have been reclassified to conform to the current period presentation. Most notably, TEP combined captions on the Condensed Consolidated Statements of Income by reclassifying similar line items into a single line item as follows:

	As Filed	Reclassification	As Reclassified
(in thousands)	Three Months Ended March 31, 2017		
Other Income (Deductions)			
Interest Income	$93	$ (93)	$ —
Other Income	9,020	(9,020)	—
Other Expense	(761)	761	—
Appreciation in Value of Investments	734	(734)	—
Allowance For Equity Funds	—	1,358	1,358
Other, Net	—	7,728	7,728
Interest Expense			
Long-Term Debt	15,436	(15,436)	—
Capital Leases	664	(664)	—
Other Interest Expense	215	(215)	—
Interest Capitalized	(530)	530	—
Allowance For Borrowed Funds	—	(530)	(530)
Interest Expense	—	16,315	16,315

Variable Interest Entities

TEP regularly reviews contracts to determine if it has a variable interest in an entity, if that entity is a Variable Interest Entity (VIE), and if it is the primary beneficiary of the VIE. The primary beneficiary is required to consolidate the VIE when the variable interest holder has: (i) the power to direct activities that most significantly impact the economic performance of the VIE; and (ii) the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE.

TEP routinely enters into long-term renewable Power Purchase Agreements (PPA) with various entities. Some of these entities are VIEs due to the long-term fixed price component in the agreements. These PPAs effectively transfer commodity price risk to TEP, the buyer of the power, creating a variable interest. TEP has determined it is not a primary beneficiary as it lacks the power to direct the activities that most significantly impact the economic performance of the VIEs. TEP reconsiders whether it is a primary beneficiary of the VIEs on a quarterly basis.

As of March 31, 2018, the carrying amount of assets and liabilities in the balance sheet that relates to variable interests under long-term PPAs is predominantly related to working capital accounts and generally represents the amounts owed by TEP for the deliveries associated with the current billing cycle. TEP's maximum exposure to loss is limited to the cost of replacing the power if the providers do not meet the production guarantee. However, the exposure to loss is mitigated as the Company would likely recover these costs through cost recovery mechanisms. See Note 2 for additional information related to cost recovery mechanisms.

Restricted Cash

Restricted cash includes cash balances restricted regarding withdrawal or usage based on contractual or regulatory considerations. The following table presents the line items and amounts of cash, cash equivalents, and restricted cash reported on the balance sheet and reconciles their sum to the cash flow statement:

	Three Months Ended March 31,	
(in millions)	2018	2017
Cash and Cash Equivalents	$20	$ 35
Restricted Cash included in:		
Investments and Other Property	10	7
Current Assets—Other	2	—
Total Cash, Cash Equivalents, and Restricted Cash	$32	$ 42

Restricted cash included in Investments and Other Property on the Condensed Consolidated Balance Sheets represents cash contractually required to be set aside to pay TEP's share of mine reclamation costs at San Juan Generating Station (San Juan). Restricted cash included in Current Assets—Other represents cash required to be set aside by various contractual agreements.

RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

Revenue from Contracts with Customers

Effective January 1, 2018, TEP adopted accounting guidance that requires recognition of revenue when a customer obtains control of promised goods or services in an amount that reflects the consideration to which the company expects to be entitled. The Company continues to recognize revenue for tariff-based sales to retail and wholesale customers, which represent TEP’s primary source of revenue, as power is delivered. TEP adopted the new guidance using the modified retrospective approach. There was no adjustment identified or recorded to the opening balance of retained earnings on adoption. The Company applied the new revenue guidance to contracts with customers that were not completed at the date of initial application, January 1, 2018. The new guidance requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. See Note 3 for additional disclosure related to TEP's operating revenues.

Compensation—Retirement Benefits

Effective January 1, 2018, TEP adopted accounting guidance that requires an employer to disaggregate the service cost component from the other components of net periodic benefit cost. TEP no longer capitalizes the non-service cost components of net periodic benefit cost as part of inventory or plant in service and presents non-service costs in Other, Net on the Condensed Consolidated Statements of Income. The adoption of this change in accounting principle did not have a material impact on TEP's financial position or results of operations.

Derivatives and Hedging

Effective January 1, 2018, TEP early adopted accounting guidance that simplifies the application of hedge accounting through changes to both the designation and measurement guidance and is intended to enable the Company to better portray the economics of its risk management activities in its financial statements. The adoption of this change in accounting principle had minimal impact to TEP's financial statements and disclosures.

Table of Contents

Reclassification of Certain Tax Effects from AOCI

Effective January 1, 2018, TEP early adopted accounting guidance that permits reclassification of certain tax effects resulting from the TCJA from accumulated other comprehensive income (AOCI) to retained earnings. TEP applied the guidance as of the beginning of the period of adoption. On adoption, TEP recorded a one-time reclassification of $1 million from Accumulated Other Comprehensive Loss to Retained Earnings on the Condensed Consolidated Balance Sheets as a result of income tax effects due to the reduction in the U.S. federal statutory tax rate. See Note 10 for additional disclosure related to the TCJA.

NOTE 2. REGULATORY MATTERS

The Arizona Corporation Commission (ACC) and the Federal Energy Regulatory Commission (FERC) each regulate portions of utility accounting practices and rates of TEP. The ACC regulates rates charged to retail customers, the siting of generation and transmission facilities, the issuance of securities, transactions with affiliated parties, and other utility matters. The ACC also enacts other regulations and policies that can affect business decisions and accounting practices. The FERC regulates terms and prices of transmission services and wholesale electricity sales.

2017 RATE ORDER

Provisions of the 2017 Rate Order, which were effective February 27, 2017, include, but are not limited to:

- a non-fuel base rate increase of $81.5 million; and
- adoption of TEP's proposed depreciation and amortization rates, which include a reduction in the depreciable life for San Juan Unit 1.

The ACC deferred matters related to net metering and rate design for new DG customers to a second phase of TEP’s rate case (Phase 2), which is currently expected to be completed in the second quarter of 2018. TEP cannot predict the outcome of these proceedings.

FEDERAL TAX LEGISLATION

Arizona Corporation Commission

In December 2017, the ACC opened a docket requesting that all regulated utilities submit proposals to address passing the ongoing benefits of the TCJA through to customers. In April 2018, the ACC approved TEP’s proposal to return the ongoing savings from the Company’s federal income tax reduction under the TCJA to its customers through a combination of a customer bill credit and a regulatory liability that reflects the deferral of the return of a portion of the savings (ACC Refund Order). The ACC Refund Order is effective May 1, 2018.

As a result of the ACC Refund Order, the Company will use a bill credit in 2018 to refund to customers: (i) $27.5 million related to the reduction in the federal corporate income tax rate; and (ii) $9 million related to the amortization of Excess Deferred Income Taxes (EDIT). TEP will continue to return savings to customers, per the ACC Refund Order, through a combination of a bill credit and a regulatory liability in 2019 and beyond. The customer bill credit will be trued-up annually to reflect actual kilowatt-hour (kWh) sales and EDIT amortization. The regulatory liability will accrue interest and be returned to customers as part of TEP's next rate case. TEP recorded $7 million in revenues subject to refund in the three months ended March 31, 2018, which reduced Operating Revenues on the Condensed Consolidated Statements of Income and increased Current Liabilities—Regulatory Liabilities on the Condensed Consolidated Balance Sheets as a result of the bill credit not becoming effective until May 2018. See Note 10 for additional information regarding the TCJA.

Federal Energy Regulatory Commission

In March 2018, the FERC issued an order directing TEP to either: (i) submit proposed revisions to its stated transmission rates or stated transmission revenue requirements to reflect the change in the federal corporate income tax rate as a result of the TCJA; or (ii) show cause why it should not be required to do so. In the same month, the FERC issued a Notice of Inquiry (NOI) regarding the effect of the TCJA. The NOI seeks comments on a number of issues including how to share the amortization of the EDIT regulatory liability balances in rates. TEP's response to the order and NOI is due in May 2018. TEP is evaluating whether its FERC-approved rates should be revised and cannot predict the impact the order or the NOI may have on results of operations in the current or future years. See Note 10 for additional information regarding the TCJA.

COST RECOVERY MECHANISMS

TEP has received regulatory decisions that allow for more timely recovery of certain costs through the recovery mechanisms described below.

Purchased Power and Fuel Adjustment Clause

TEP's Purchased Power and Fuel Adjustment Clause (PPFAC) rate is adjusted annually each April 1st and goes into effect for the subsequent 12-month period unless modified by the ACC. The PPFAC rate includes: (i) a forward component which is calculated by taking the difference between forecasted fuel and purchased power costs and the amount of those costs established in rates designed to allow a regulated utility recovery of its costs of providing services and an opportunity to earn a reasonable return on its investment (Retail Rates); and (ii) a true-up component that reconciles the difference between actual costs and those recovered in the preceding 12-month period. The PPFAC bank balance was over-collected by $4 million as of March 31, 2018 and by $9 million as of December 31, 2017.

The table below presents TEP's PPFAC rates approved by the ACC:

Period	Cents per kWh
May 2018 through March 2019	0.20
March 2017 through April 2018 [1]	(0.20)
May 2016 through February 2017	0.15

(1) In February 2017, the ACC approved a PPFAC credit to begin returning the over-collected PPFAC bank balance to customers until the effective date of the 2018 PPFAC rate.

Renewable Energy Standard

The ACC’s Renewable Energy Standard (RES) requires Arizona regulated utilities to increase their use of renewable energy each year until it represents at least 15% of their total annual retail energy requirements by 2025, with DG accounting for 30% of the annual renewable energy requirement. Arizona utilities must file an annual RES implementation plan for review and approval by the ACC.

In January 2018, the ACC approved TEP's 2018 RES implementation plan with a budget amount of $54 million. The recovery funds the following: (i) the above market cost of renewable power purchases; (ii) previously awarded performance-based incentives for customer-installed DG; and (iii) various other program costs.

Energy Efficiency Standards

TEP is required to implement cost-effective Demand Side Management (DSM) programs to comply with the ACC's Energy Efficiency Standards (EE Standards). The EE Standards provide regulated utilities a DSM surcharge to recover from retail customers the costs to implement DSM programs, as well as an annual performance incentive. Energy savings realized through the programs count toward meeting the EE Standards and the associated lost revenue are partially recovered through the Lost Fixed Cost Recovery (LFCR) mechanism.

TEP earns the DSM performance incentive by meeting objectives stated in its energy efficiency implementation plan. The Company records its annual DSM performance incentive for the prior calendar year in the first quarter of each year, with $2 million recorded in both 2018 and 2017, included in Operating Revenues on the Condensed Consolidated Statements of Income.

Lost Fixed Cost Recovery Mechanism

The LFCR mechanism provides for recovery of certain non-fuel costs that would go unrecovered due to reduced retail kWh sales as a result of implementing ACC-approved energy efficiency programs and customer-installed DG. TEP records a regulatory asset and recognizes LFCR revenues when the amounts are verifiable regardless of when the lost retail kWh sales occur. TEP is required to make an annual filing with the ACC requesting recovery of the LFCR revenues recognized in the prior year. The recovery is subject to a year-over-year cap of 2% of TEP's applicable retail revenues, as approved in the 2017 Rate Order.

TEP recorded regulatory assets and recognized LFCR revenues of $8 million and $6 million in the three months ended March 31, 2018 and 2017, respectively. LFCR revenues are included in Operating Revenues on the Condensed Consolidated Statements of Income.

Table of Contents

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

REGULATORY ASSETS AND LIABILITIES

Regulatory assets and liabilities recorded in the balance sheet are summarized in the table below:

($ in millions)	Remaining Recovery Period (years)	March 31, 2018	December 31, 2017
Regulatory Assets			
Pension and Other Postretirement Benefits	Various	$ 124	$ 126
Early Generation Retirement Costs [1]	Various		