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.

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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

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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.

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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)

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.

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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.

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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.

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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.

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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	81	84
Income Taxes Recoverable through Future Rates	Various	40	40
Derivatives	3	36	18
Final Mine Reclamation and Retiree Healthcare Costs [(2)]	19	34	31
Lost Fixed Cost Recovery	2	33	29
Property Tax Deferrals	1	24	24
Springerville Unit 1 Leasehold Improvements [(3)]	5	13	14
Other Regulatory Assets	Various	22	22
Total Regulatory Assets		407	388
Less Current Portion	1	109	94
Total Non-Current Regulatory Assets		$ 298	$ 294
Regulatory Liabilities			
Income Taxes Payable through Future Rates [(4)]	Various	$353	$353
Net Cost of Removal [(5)]	Various	178	180
Renewable Energy Standard	Various	47	44
Deferred Investment Tax Credits	Various	13	14
Other Regulatory Liabilities	Various	14	14
Total Regulatory Liabilities		605	605
Less Current Portion	1	93	89
Total Non-Current Regulatory Liabilities		$512	$516

(1) Includes the net book value (NBV) and other related costs of Navajo Generating Station (Navajo) and H. Wilson Sundt Generating Station (Sundt) Units 1 and 2 reclassified from Utility Plant, Net on the Condensed Consolidated Balance Sheets due to the planned early retirement of the facilities. Navajo and Sundt Units 1 and 2 are being fully recovered in base rates using various useful lives through 2030.

(2) Represents costs associated with TEP's jointly-owned facilities at San Juan, Four Corners Generating Station (Four Corners), and Navajo. TEP recognizes these costs at future value and is permitted to recover these costs through the PPFAC mechanism. The majority of final mine reclamation costs are expected to occur through 2037.

(3) Represents investments TEP made, which were previously recorded in Plant in Service on the Condensed Consolidated Balance Sheets, to ensure that the facilities continued to provide service to TEP's customers. TEP received ACC authorization to recover leasehold improvement costs at Springerville Generating Station (Springerville) Unit 1 over a 10-year amortization period.

(4) Includes balances related to EDIT as a result of the revaluation of deferred income taxes in 2017 due to the TCJA. TEP is amortizing the EDIT balances in accordance with applicable federal income tax laws, which require the amortization of a majority of the balance over the remaining life of the related asset. In April 2018, the ACC Refund Order was approved requiring TEP to share EDIT amortization of the ACC-jurisdictional assets with customers. See Note 10 for additional information regarding the TCJA.

(5) Represents an estimate of the future cost of retirement net of salvage value. These are amounts collected through revenue for transmission, distribution, and generation plant and general and intangible plant which are not yet expended.

Regulatory assets are either being collected or are expected to be collected through Retail Rates. With the exception of Early Generation Retirement Costs and Springerville Unit 1 Leasehold Improvements, TEP does not earn a return on regulatory assets. Regulatory liabilities represent items that TEP either expects to pay to customers through billing reductions in future periods or plans to use for the purpose for which they were collected from customers. TEP does not pay a return on regulatory liabilities.

FERC COMPLIANCE

In 2016, the FERC issued orders relating to certain late-filed transmission service agreements (TSAs), which resulted in TEP paying time-value refunds to the counterparties of these TSAs. In January 2017, TEP and one of the TSA counterparties entered into a settlement agreement resulting in the counterparty paying TEP $8 million. The settlement amount was recorded in Other, Net on the Condensed Consolidated Statements of Income. As a result of the settlement, TEP dismissed a previously filed appeal. In May 2017, the FERC informed TEP that the related investigation was closed.

NOTE 3. REVENUE

TEP earns the majority of its revenues from the sale of power to retail and wholesale customers based on regulator-approved tariff rates. Most of the Company's contracts have a single performance obligation, the delivery of power. TEP satisfies the performance obligation over time as power is delivered and control is transferred to the customer. The Company bills for power sales based on the reading of electric meters on a systematic basis throughout the month. In general, TEP's contracts have payment terms of 10 to 20 weekdays from the date the bill is rendered. TEP considers any payment not received by the due date delinquent and charges the customer a late payment fee. No component of the transaction price is allocated to unsatisfied performance obligations.

TEP has certain contracts with variable transaction pricing that require it to estimate the resulting variable consideration. TEP's variable consideration includes revenues that are subject to refund and performance incentive revenues. TEP estimates variable consideration at the most likely amount to which the Company expects to be entitled and recognizes a refund liability until TEP is certain that the Company will be entitled to the consideration. The Company includes estimated amounts of variable consideration in the transaction price to the extent it is probable that changes in its estimate will not result in significant reversals of revenue in subsequent periods.

DISAGGREGATION OF REVENUES

The following table presents the disaggregation of TEP’s Operating Revenues on the Condensed Consolidated Statements of Income by type of service:

	Three Months Ended March 31,	
(in millions)	2018	2017
Retail	$192	$191
Wholesale	38	35
Other Services	23	22
Revenues from Contracts with Customers	253	248
Alternative Revenues	9	8
Other	13	12
Total Operating Revenues	$275	$268

Retail Revenues

TEP’s tariff-based sales to residential, commercial, and industrial customers are regulated by the ACC and recognized when power is delivered at the amount of consideration that the Company expects to receive in exchange. Retail Revenues includes an estimate for unbilled revenues from service that has been provided but not billed by the end of an accounting period. At the end of the month, amounts of power delivered since the last meter reading are estimated and the corresponding unbilled revenue is calculated using anticipated Retail Rates. Unbilled revenues are dependent upon a number of factors that require management’s judgment including estimates of retail sales, customer usage patterns, and pricing. Once the usage is estimated, TEP applies the anticipated rate and records revenue. Unbilled revenues increase during the spring and summer months and decrease during the fall and winter months due to the seasonal fluctuations of TEP's actual load. The timing of revenue recognition, billings, and cash collections results in billed and unbilled accounts receivable balances on the balance sheet. See Note 4 for components of Accounts Receivable, Net on the Condensed Consolidated Balance Sheets.

In January 2018, TEP began recognizing a provision for revenues subject to refund, which reduces operating revenues, and a current regulatory liability for amounts that are expected to be refunded to customers due to the reduction of the federal corporate income tax rate. See Note 2 and Note 10 for more information regarding the impact of the TCJA on regulator-approved rates.

Wholesale Revenues

TEP's operations include the wholesale marketing of electricity and transmission to other utilities and power marketers, which may include capacity, power, transmission, and ancillary services. When TEP promises to provide distinct services within a contract, the Company separates the contract into more than one performance obligation. The Company recognizes revenue for wholesale and transmission sales at FERC-approved rates based on demand (for capacity) or the reading of meters (for power). For contracts with multiple performance obligations, all deliverables are eligible for recognition in the month of production; therefore, it is not necessary to allocate the transaction price among the identified performance obligations.

Other Services Revenues

Other Services Revenues primarily include management fees for Springerville Unit 3, miscellaneous service-related revenues, and reimbursement of various operating expenses for the use of the Springerville Common Facilities by Springerville Units 3 and 4 and the Springerville Coal Handling Facilities by Springerville Unit 3. As the operating agent for the third-party owner of Springerville Unit 3, TEP may earn an annual incentive or be required to refund its monthly management fee based on unit availability.

Alternative Revenues

Alternative Revenue programs allow utilities to adjust future rates in response to past activities or completed events if certain criteria established by a regulator are met. TEP has identified its LFCR mechanism and DSM performance incentive as alternative revenues. See Note 2 for additional information regarding these cost recovery mechanisms.

Other Revenues

Other Revenues include gains and losses on derivative contracts, late and returned payment finance charges, and lease income. See Note 9 for information regarding derivative instruments.

NOTE 4. ACCOUNTS RECEIVABLE

The following table presents the components of Accounts Receivable, Net on the Condensed Consolidated Balance Sheets:

(in millions)	March 31, 2018	December 31, 2017
Customer [(1)]	$ 75	$ 81
Customer, Unbilled	35	39
Due from Affiliates (Note 5)	8	7
Other	17	16
Allowance for Doubtful Accounts	(5)	(5)
Accounts Receivable, Net	$ 130	$ 138

(1) Includes $8 million as of March 31, 2018 and $9 million as of December 31, 2017, of receivables related to revenue from derivative instruments.

NOTE 5. RELATED PARTY TRANSACTIONS

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents the components of related party balances included in Accounts Receivable, Net and Accounts Payable on the Condensed Consolidated Balance Sheets:

(in millions)	March 31, 2018	December 31, 2017
Receivables from Related Parties		
UNS Electric	$ 4	$ 5
UNS Gas	2	2
UNS Energy	2	—
Total Due from Related Parties	$ 8	$ 7
Payables to Related Parties		
SES	$ 1	$ 3
UNS Energy	1	1
UNS Electric	1	—
Total Due to Related Parties	$ 3	$ 4

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

(in millions)	Three Months Ended March 31, 2018	2017
Goods and Services Provided by TEP to Affiliates		
Transmission Revenues, UNS Electric [1]	$ 2	$ 1
Control Area Services, UNS Electric [2]	—	1
Common Costs, UNS Energy Affiliates [3]	4	4
Goods and Services Provided by Affiliates to TEP		
Supplemental Workforce, SES [4]	3	3
Corporate Services, UNS Energy [5]	2	1
Corporate Services, UNS Energy Affiliates [6]	2	1

(1) TEP and UNS Electric sell power and transmission services to each other. Wholesale power is sold at prevailing market prices while transmission services are sold at FERC-approved rates through the applicable Open Access Transmission Tariff.

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

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

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

(5) Costs for Corporate Services at UNS Energy are allocated to its subsidiaries using the Massachusetts Formula, an industry accepted method of allocating common costs to affiliated entities. TEP's allocation is approximately 82% of UNS Energy's allocated costs. Corporate Services, UNS Energy includes legal, audit, and Fortis management fees. TEP's share of Fortis' management fees for the three months ended March 31, 2018 and 2017 were $2 million

and $1 million, respectively.

(6) Costs for Corporate Services (e.g., finance, accounting, tax, legal, and information technology) and other labor services for UNS Energy Affiliates are directly assigned to the benefiting entity at a fully burdened cost when possible.

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NOTE 6. DEBT, CREDIT FACILITY, AND CAPITAL LEASE OBLIGATIONS

There have been no significant changes to TEP's debt, credit facility, or capital lease obligations from those reported in its 2017 Annual Report on Form 10-K, except as noted below.

CREDIT FACILITY

As of March 31, 2018, there was $219 million available under the revolving credit commitments and Letter of Credit (LOC) facilities. As of April 30, 2018, TEP had $190 million available under its revolving credit commitments and LOC facilities.

COVENANT COMPLIANCE

As of March 31, 2018, TEP was in compliance with the terms of its credit and long-term debt agreements.

NOTE 7. COMMITMENTS AND CONTINGENCIES

COMMITMENTS

In addition to those reported in our 2017 Annual Report on Form 10-K, TEP entered into the following long-term commitments through March 31, 2018:

(in millions)	2018	2019	2020	2021	2022	Thereafter	Total
Fuel, Including Transportation	$ 4	$ 5	$ 5	$ 5	$ 5	$ 1	$ 25

Fuel, Including Transportation

TEP has firm transportation agreements with capacity sufficient to meet its load requirements. These agreements expire in various years between 2018 and 2040. In January 2018, TEP entered into a transportation agreement with El Paso Natural Gas Company, LLC, extending the expiration date of the existing agreement from April 2018 to April 2023.

CONTINGENCIES

Legal Matters

TEP is party to a variety of legal actions arising out of the normal course of business. Plaintiffs occasionally seek punitive or exemplary damages. TEP believes such normal and routine litigation will not have a material impact on its financial results. TEP is also involved in other kinds of legal actions, some of which assert or may assert claims or seek to impose fines, penalties, and other costs in substantial amounts on TEP and are disclosed below.

Claims Related to San Juan Generating Station

WildEarth Guardians

In 2013, WildEarth Guardians (WEG) filed a Petition for Review in the U.S. District Court for the District of Colorado against the Office of Surface Mining (OSM) challenging several unrelated mining plan modification approvals, including two issued in 2008 related to San Juan Coal Company’s (SJCC) San Juan Mine. The petition alleges various National Environmental Policy Act (NEPA) violations against the OSM, including: (i) failure to provide requisite public notice and participation, and (ii) failure to analyze certain environmental impacts. WEG’s petition seeks various forms of relief, including voiding and remanding the various mining modification approvals, enjoining the federal defendants from re-issuing the approvals until they can demonstrate compliance with the NEPA, and enjoining operations at the affected mines. SJCC intervened in this matter and was granted its motion to sever its claims from the lawsuit and transfer venue to the U.S. District Court for the District of New Mexico, where this matter is now pending. In July 2016, the federal defendants filed a motion asking that the matter be voluntarily remanded to the OSM so the OSM may prepare a new environmental impact statement (EIS) under the NEPA regarding the impacts of the San Juan Mine mining plan approval. In August 2016, the court issued an order granting the motion for remand to conduct further environmental analysis and complete an EIS by August 31, 2019. The order provides that: (i) the OSM's decision approving the mining plan will remain in effect during this process; or (ii) if the EIS is not completed by August 31, 2019, then the approved mine plan will immediately be vacated, absent further court order. The draft EIS is expected to be available for public comment in the second quarter of 2018. TEP cannot currently predict the outcome of this matter or the range of its potential impact.

Mine Reclamation at Generation Facilities Not Operated by TEP

TEP pays ongoing mine reclamation costs related to coal mines that supply generation facilities in which TEP has an ownership interest but does not operate. TEP is also liable for a portion of final mine reclamation costs upon closure of the mines servicing Navajo, San Juan, and Four Corners. TEP’s share of reclamation costs at all three mines is expected to be $69 million upon expiration of the coal supply agreements, which expire between 2019 and 2031. The balance sheet reflected a total liability related to reclamation of $35 million as of March 31, 2018 and $34 million as of December 31, 2017.

Amounts recorded for final mine reclamation are subject to various assumptions, such as estimations of reclamation costs, the dates when final reclamation will occur, and the expected inflation rate. 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 the Company to pass through final mine reclamation costs, as a component of fuel costs, to retail customers. Therefore, TEP classifies these costs as a regulatory asset by increasing the regulatory asset and the reclamation liability over the remaining life of the coal supply agreements and recovers the regulatory asset through the PPFAC as final mine reclamation costs are paid to the coal suppliers.

Performance Guarantees

TEP has joint participation agreements with participants at Navajo, San Juan, Four Corners, and Luna Generating Station (Luna). The participants in each of the generation facilities, including TEP, have guaranteed certain performance obligations. Specifically, in the event of payment default, each non-defaulting participant has agreed to bear its proportionate share of expenses otherwise payable by the defaulting participant. In exchange, the non-defaulting participants are entitled to receive their proportionate share of the generation capacity of the defaulting participant. With the exception of Four Corners, there is no maximum potential amount of future payments TEP could be required to make under the guarantees. The maximum potential amount of future payments is $250 million at Four Corners. As of March 31, 2018, there have been no such payment defaults under any of the participation agreements. The Navajo participation agreement expires in 2019, San Juan in 2022, Four Corners in 2041, and Luna in 2046.

Environmental Matters

TEP is subject to federal, state, and local environmental laws and regulations regarding air and water quality, renewable portfolio standards, emissions performance standards, climate change, coal combustion byproduct disposal, hazardous and solid waste disposal, protected species, and other environmental matters that have the potential to impact TEP's current and future operations. Environmental laws and regulations are subject to a range of interpretations, which may ultimately be resolved by the courts. Because these laws and regulations continue to evolve, TEP is unable to predict the impact of the changing laws and regulations on its operations and financial results. TEP expects to recover the cost of environmental compliance from its ratepayers. TEP believes it is in material compliance with applicable environmental laws and regulations.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 8. EMPLOYEE BENEFIT PLANS

Net periodic benefit cost includes the following components:

	Pension Benefits		Other Postretirement Benefits	
	Three Months Ended March 31,			
(in millions)	2018	2017	2018	2017
Service Cost	$4	$3	$1	$1
Interest Cost	4	4	—	—
Expected Return on Plan Assets	(7)	(6)	—	—
Amortization of Net Loss	2	2	—	—
Net Periodic Benefit Cost	$3	$3	$1	$1

The non-service components of net periodic benefit cost are included in Other, Net on the Condensed Consolidated Statements of Income.

NOTE 9. FAIR VALUE MEASUREMENTS AND DERIVATIVE INSTRUMENTS

TEP categorizes financial instruments into the three-level hierarchy based on inputs used to determine the fair value. Level 1 inputs are unadjusted quoted prices for identical assets or liabilities in an active market. Level 2 inputs include quoted prices for similar assets or liabilities, quoted prices in non-active markets, and pricing models whose inputs are observable, directly or indirectly. Level 3 inputs are unobservable and supported by little or no market activity. Transfers between levels are recorded at the end of a reporting period. There were no transfers between levels in the periods presented.

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A RECURRING BASIS

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

	Level 1	Level 2	Level 3	Total
(in millions)	March 31, 2018			
Assets				
Cash Equivalents(1)	$15	$—	$—	$15
Restricted Cash(1)	12	—	—	12
Energy Derivative Contracts, Regulatory Recovery(2)	—	9	1	10
Energy Derivative Contracts, No Regulatory Recovery(2)	—	—	2	2
Total Assets	27	9	3	39
Liabilities				
Energy Derivative Contracts, Regulatory Recovery(2)	—	(45)	(1)	(46)
Energy Derivative Contracts, No Regulatory Recovery(2)	—	—	(1)	(1)
Interest Rate Swap(3)	—	(1)	—	(1)
Total Liabilities	—	(46)	(2)	(48)
Total Assets (Liabilities), Net	$27	$(37)	$1	$(9)

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(in millions)	December 31, 2017			
Assets				
Cash Equivalents[1]	$30	$—	$—	$30
Restricted Cash[1]	12	—	—	12
Energy Derivative Contracts, Regulatory Recovery[2]	—	9	—	9
Energy Derivative Contracts, No Regulatory Recovery[2]	—	—	3	3
Total Assets	42	9	3	54
Liabilities				
Energy Derivative Contracts, Regulatory Recovery[2]	—	(26)	—	(26)
Energy Derivative Contracts, No Regulatory Recovery[2]	—	—	(1)	(1)
Interest Rate Swap[3]	—	(1)	—	(1)
Total Liabilities	—	(27)	(1)	(28)
Total Assets (Liabilities), Net	$42	$(18)	$2	$26

(1) Cash Equivalents and Restricted Cash represent amounts held in money market funds and certificates of deposit valued at cost, including interest, which approximates fair market value. Cash Equivalents are included in Cash and Cash Equivalents on the Condensed Consolidated Balance Sheets. Restricted cash is included in Investments and Other Property and in Current Assets—Other on the Condensed Consolidated Balance Sheets.

(2) Energy Derivative Contracts include gas swap agreements (Level 2) and forward purchased power and sales contracts (Level 3) entered into to reduce exposure to energy price risk. These contracts are included in Derivative Instruments on the Condensed Consolidated Balance Sheets.

(3) The Interest Rate Swap is valued using an income valuation approach based on the 6-month London Interbank Offered Rate and is included in Derivative Instruments on the Condensed Consolidated Balance Sheets.

All energy derivative contracts are subject to legally enforceable master netting arrangements to mitigate credit risk. TEP presents derivatives on a gross basis in the balance sheet. The tables below present the potential offset of counterparty netting and cash collateral.

(in millions)	Gross Amount Recognized in the Balance Sheets	Gross Amount Not Offset in the Balance Sheets: Counterparty Netting of Energy Contracts	Cash Collateral Received/Posted	Net Amount
	March 31, 2018			
Derivative Assets				
Energy Derivative Contracts	$12	$ 11	$ —	$ 1
Derivative Liabilities				
Energy Derivative Contracts	(47)	(11)	—	(36)
Interest Rate Swap	(1)	—	—	(1)

(in millions)	December 31, 2017
Derivative Assets	