TUCSON ELECTRIC POWER CO
Form 10-Q
July 28, 2017

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2017
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 July 27, 2017.

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DEFINITIONS

The abbreviations and acronyms used in the second quarter 2017 Form 10-Q are defined below:

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
APS	Arizona Public Service Company
BART	Best Available Retrofit Technology
BBtu	Billion British thermal units
Cooling Degrees Days	An index used to measure the impact of weather on energy usage calculated by subtracting 75 from the average of the high and low daily temperatures
DG	Distributed Generation
DSM	Demand Side Management
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
GWh	Gigawatt-hour(s)
Heating Degree Days	An index used to measure the impact of weather on energy usage calculated by subtracting the average of the high and low daily temperatures from 65
kWh	Kilowatt-hour(s)
LFCR	Lost Fixed Cost Recovery
LOC	Letter(s) of Credit
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
PNM	Public Service Company of New Mexico
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
SES	Southwest Energy Solutions, Inc.
SJCC	San Juan Coal Company
Springerville	Springerville Generating Station
SRP	Salt River Project Agricultural Improvement and Power District
Sundt	H. Wilson Sundt Generating Station
TEP	Tucson Electric Power Company, the principal subsidiary of UNS Energy Corporation
Third-Party Owners	Wilmington Trust Company and William J. Wade, as Owner Trustee and Co-trustee under a separate trust agreement with each of Alterna Springerville LLC (Alterna) and LDVF1 TEP LLC (LDVF1) (Alterna and LDVF1, together with the Owner Trustees and Co-trustees, the Third-Party Owners)

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 operational, economical, 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 2016 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; changes in, and compliance with, environmental laws and regulation decisions and policies that could increase operating and capital costs, reduce generating facility output, or accelerate generating facility retirements; regional economic and market conditions which could affect customer growth and energy usage; changes in energy consumption by retail customers; weather variations affecting energy usage; the cost of debt and equity capital and access to capital markets and bank markets; the performance of the stock market and changing interest rate environment, which affect the value of our pension and other postretirement benefit plan assets and the related contribution requirements and expense; 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; and the performance of TEP's generating facilities.

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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 June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Operating Revenues				
Retail	$280,537	$256,450	$480,043	$460,403
Wholesale	43,836	34,084	86,374	48,497
Other	27,771	26,950	54,109	52,063
Total Operating Revenues	352,144	317,484	620,526	560,963
Operating Expenses				
Fuel	59,744	68,236	126,472	130,914
Purchased Power	43,841	24,023	68,136	41,763
Transmission and Other PPFAC Recoverable Costs	7,983	5,312	16,882	10,490
Increase (Decrease) to Reflect PPFAC Recovery Treatment	(7,417)	7,470	(15,607)	14,265
Total Fuel and Purchased Power	104,151	105,041	195,883	197,432
Operations and Maintenance	84,490	86,580	166,631	171,579
Depreciation	38,208	35,913	76,365	71,545
Amortization	5,458	5,545	10,860	11,021
Taxes Other Than Income Taxes	12,980	12,700	26,780	25,730
Total Operating Expenses	245,287	245,779	476,519	477,307
Operating Income	106,857	71,705	144,007	83,656
Other Income (Deductions)				
Interest Income	433	29	526	67
Other Income	1,872	1,260	10,892	2,653
Other Expense	(776)	(463)	(1,537)	(886)
Appreciation in Value of Investments	484	660	1,218	860
Total Other Income (Deductions)	2,013	1,486	11,099	2,694
Interest Expense				
Long-Term Debt	15,494	15,486	30,930	30,977
Capital Leases	664	855	1,328	1,713
Other Interest Expense	208	135	423	258
Interest Capitalized	(590)	(397)	(1,120)	(861)
Total Interest Expense	15,776	16,079	31,561	32,087
Income Before Income Taxes	93,094	57,112	123,545	54,263
Income Tax Expense	32,159	16,576	41,851	14,429
Net Income	$60,935	$40,536	$81,694	$39,834

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Comprehensive Income				
Net Income	$60,935	$40,536	$81,694	$39,834
Other Comprehensive Income				
Net Changes in Fair Value of Cash Flow Hedges:				
Net of Income Tax Expense of $59 and $81	96	129		
Net of Income Tax Expense of $133 and $87			215	138
Supplemental Executive Retirement Plan Adjustments:				
Net of Income Tax Expense of $43 and $35	70	57		
Net of Income Tax Expense of $86 and $70			140	113
Total Other Comprehensive Income, Net of Tax	166	186	355	251
Total Comprehensive Income	$61,101	$40,722	$82,049	$40,085

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

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

	Six Months Ended June 30,	
	2017	2016
Cash Flows from Operating Activities		
Net Income	$81,694	$39,834
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation Expense	76,365	71,545
Amortization Expense	10,860	11,021
Amortization of Debt Issuance Costs	1,178	1,451
Use of Renewable Energy Credits for Compliance	11,245	8,403
Deferred Income Taxes	41,855	14,428
Pension and Other Postretirement Benefits Expense	8,019	7,669
Pension and Other Postretirement Benefits Funding	(5,165)	(5,694)
Allowance for Equity Funds Used During Construction	(2,792)	(2,203)
FERC Transmission Refund Payable	(4,878)	10,086
Changes in Current Assets and Current Liabilities:		
Accounts Receivable	(44,596)	(21,707)
Materials, Supplies, and Fuel Inventory	(4,825)	4,151
Regulatory Assets	(7,217)	(8,579)
Accounts Payable and Accrued Charges	26,848	11,985
Regulatory Liabilities	(10,299)	13,588
Other, Net	(8,475)	550
Net Cash Flows—Operating Activities	169,817	156,528
Cash Flows from Investing Activities		
Capital Expenditures	(151,207)	(135,344)
Purchase Intangibles, Renewable Energy Credits	(27,330)	(19,570)
Contributions in Aid of Construction	2,917	(722)
Other, Net	(975)	—
Net Cash Flows—Investing Activities	(176,595)	(155,636)
Cash Flows from Financing Activities		
Proceeds from Borrowings, Revolving Credit Facilities	15,000	—
Repayments of Borrowings, Revolving Credit Facilities	(15,000)	—
Payments of Capital Lease Obligations	(14,463)	(13,703)
Other, Net	320	(4,028)
Net Cash Flows—Financing Activities	(14,143)	(17,731)
Net Decrease in Cash and Cash Equivalents	(20,921)	(16,839)
Cash and Cash Equivalents, Beginning of Period	35,962	55,684
Cash and Cash Equivalents, End of Period	$15,041	$38,845

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)

	June 30, 2017	December 31, 2016
ASSETS		
Utility Plant		
Plant in Service	$5,683,029	$5,975,139
Utility Plant Under Capital Leases	167,413	167,413
Construction Work in Progress	152,401	129,955
Total Utility Plant	6,002,843	6,272,507
Accumulated Depreciation and Amortization	(2,164,791)	(2,385,053)
Accumulated Amortization of Capital Lease Assets	(107,998)	(104,648)
Total Utility Plant, Net	3,730,054	3,782,806
Investments and Other Property	46,277	45,020
Current Assets		
Cash and Cash Equivalents	15,041	35,962
Accounts Receivable, Net	173,410	124,934
Fuel Inventory	29,686	25,887
Materials and Supplies	101,584	97,126
Regulatory Assets	66,846	56,340
Derivative Instruments	5,876	4,966
Other	15,977	13,793
Total Current Assets	408,420	359,008
Regulatory and Other Assets		
Regulatory Assets	253,746	225,453
Derivative Instruments	403	330
Other	49,941	37,372
Total Regulatory and Other Assets	304,090	263,155
Total Assets	$4,488,841	$4,449,989

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)

	June 30, 2017	December 31, 2016
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 June 30, 2017, and December 31, 2016)	$1,296,539	$1,296,539
Capital Stock Expense	(6,357)	(6,357)
Retained Earnings	355,102	273,408
Accumulated Other Comprehensive Loss	(4,200)	(4,555)
Total Common Stock Equity	1,641,084	1,559,035
Preferred Stock (No Par Value, 1,000,000 Shares Authorized, None Outstanding as of June 30, 2017, and December 31, 2016)	—	—
Capital Lease Obligations	28,164	39,267
Long-Term Debt, Net	1,453,747	1,453,072
Total Capitalization	3,122,995	3,051,374
Current Liabilities		
Capital Lease Obligations	48,110	51,765
Accounts Payable	108,921	89,797
Accrued Taxes Other than Income Taxes	41,578	37,639
Accrued Employee Expenses	23,638	29,465
Accrued Interest	14,635	14,508
Regulatory Liabilities	65,887	76,069
Customer Deposits	24,965	25,778
Derivative Instruments	3,671	2,641
Other	15,209	17,837
Total Current Liabilities	346,614	345,499
Regulatory and Other Liabilities		
Deferred Income Taxes, Net	575,038	529,148
Regulatory Liabilities	213,999	300,700
Pension and Other Postretirement Benefits	131,061	131,630
Derivative Instruments	5,576	2,629
Other	93,558	89,009
Total Regulatory and Other Liabilities	1,019,232	1,053,116
Commitments and Contingencies		
Total Capitalization and Other Liabilities	$4,488,841	$4,449,989

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, 2015	$1,296,539	$(6,357)	$189,317	$ (4,564)	$ 1,474,935
Net Income			39,834		39,834
Other Comprehensive Income, Net of Tax				251	251
Adoption of ASU, Cumulative Effect Adjustment			9,653		9,653
Balances as of June 30, 2016	$1,296,539	$(6,357)	$238,804	$ (4,313)	$ 1,524,673

	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			81,694		81,694
Other Comprehensive Income, Net of Tax				355	355
Balances as of June 30, 2017	$1,296,539	$(6,357)	$355,102	$ (4,200)	$ 1,641,084

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 422,000 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 income statement. 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 2016 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. TEP's Condensed Consolidated Statements of Cash Flows reflect a reclassification from Provision for Springerville Unit 1 - Third-Party Owners Unrealized Revenue to Changes in Current Assets and Current Liabilities—Accounts Receivable of $12 million for the six months ended June 30, 2016.

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 Purchased Power 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 June 30, 2017, 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 retail customer cost recovery mechanisms. See Note 2 for additional information related to cost recovery mechanisms.

RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

Effective January 1, 2016, TEP adopted accounting guidance that simplifies the accounting for share-based payment accounting. The guidance requires that excess tax benefits and tax deficiencies be recorded as an income tax benefit or expense on the income statement and eliminates the requirement that excess tax benefits be realized before companies can recognize them. On adoption, using the modified retrospective method of transition, TEP recorded a cumulative effect adjustment of $10 million to increase retained earnings and decrease deferred income taxes related to prior period unrecognized excess tax benefits. The impact on the income and the cash flow statements was not significant. TEP elected to recognize forfeitures when they occur.

Effective January 1, 2017, TEP adopted accounting guidance that requires the Company to measure inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The adoption of this change in accounting principle did not have any impact on TEP as the Company recovers the cost of inventory through its rates.

UTILITY PLANT

Utility Plant includes the business property and equipment that supports electric service, consisting primarily of generation, transmission, and distribution facilities. Utility plant is reported at original cost. Original cost includes materials and labor, contractor services, construction overhead (when applicable), and an Allowance for Funds Used During Construction, less contributions in aid of construction.

Retirements

As of June 30, 2017, TEP recorded the early retirement of Unit 2 of the San Juan Generating Station (San Juan) and the coal handling facilities at H. Wilson Sundt Generating Station (Sundt) in accordance with the 2017 Rate Order. As a result of the 2017 Rate Order, the Condensed Consolidated Balance Sheets reflect a: (i) $224 million decrease in Plant in Service and Accumulated Depreciation and Amortization related to San Juan Unit 2; and (ii) $14 million decrease in Regulatory Assets and Accumulated Depreciation and Amortization related to the coal handling facilities at Sundt. See Note 2 for additional information related to the 2017 Rate Order.

Also in June 2017, the Navajo Nation approved a land lease extension which allows TEP and the co-owners of Navajo Generating Station (Navajo) to continue operations through December 2019 and begin decommissioning activities thereafter. TEP is currently recovering Navajo capital and operating costs in base rates using a useful life of 2030. As a result of the planned early retirement of Navajo, $38 million of the facility's net book value (NBV) and other related costs were reclassified from Utility Plant, Net to Regulatory Assets on the Condensed Consolidated Balance Sheets.

Depreciation

Depreciation is recorded for owned utility plant on a group method straight-line basis at depreciation rates based on the economic lives of the assets. The Arizona Corporation Commission (ACC) approves depreciation rates for all generation and distribution assets. Transmission assets are subject to the jurisdiction of the Federal Energy Regulatory Commission (FERC). In the 2017 Rate Order, the ACC approved the results of a new depreciation study for TEP. To reflect the impact of the revised depreciation study on the estimated cost of removal, TEP transferred $87 million from Regulatory Liabilities to Accumulated Depreciation and Amortization on the Condensed Consolidated Balance Sheets as of June 30, 2017. See Note 2 for additional information related to the net cost of removal balance in Regulatory Liabilities.

NOTE 2. REGULATORY MATTERS

The ACC and the 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

In February 2017, the ACC issued a rate order for new rates that took effect February 27, 2017 (2017 Rate Order). Provisions of the 2017 Rate Order include, but are not limited to:

- a non-fuel base rate increase of $81.5 million, which includes $15 million of operating costs related to the 50.5% undivided interest in Unit 1 of Springerville Generating Station (Springerville) purchased by TEP in September 2016;
- a 7.04% return on original cost rate base, which includes a cost of equity component of 9.75% and a cost of debt component of 4.32%;
- adoption of TEP's proposed depreciation and amortization rates, which include a reduction in the depreciable life for San Juan Unit 1; and

- approval of a request to apply excess depreciation reserves against the unrecovered NBV of San Juan Unit 2 and the coal handling facilities at Sundt due to early retirement.

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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 first quarter of 2018. TEP cannot predict the outcome of these proceedings.

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 $25 million as of June 30, 2017 and by $38 million as of December 31, 2016.

In February 2017, the ACC approved a PPFAC credit to begin returning the over-collected balance to customers. The table below presents TEP's PPFAC rates approved by the ACC:

Period	Cents per kWh
March 2017 through March 2018	(0.20)
May 2016 through February 2017	0.15
April 2015 through April 2016	0.68

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 March 2017, the ACC approved TEP's 2017 RES implementation plan of $54 million, which was partially offset by applying $2 million of previously recovered carryover funds. TEP has been approved to recover the remaining $52 million through the RES surcharge. 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. TEP suspended its rooftop solar program effective December 2016, but requested approval of a community solar program. The ACC is expected to consider this program in Phase 2 of TEP's rate case.

The percentage of retail kilowatt-hour (kWh) sales attributable to the RES in 2016 was 11%, which exceeded the overall 2016 RES renewable energy requirement of 6%. Compliance is determined through the ACC's review of TEP's annual RES implementation plan. As TEP no longer pays incentives to obtain DG renewable energy credits, which are used to demonstrate compliance with the DG requirement, the ACC approved a waiver of the 2016 and 2017 residential DG requirement.

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 the costs to implement DSM programs from retail customers, as well as, an annual performance incentive. TEP records its annual DSM performance incentive for the prior calendar year in the first quarter of each year, with $2 million recorded in both 2017 and 2016. This performance incentive is included in Retail Revenues on the Condensed Consolidated Statements of Income.

In February 2016, the ACC approved TEP's 2016 energy efficiency implementation plan which included a budget of approximately $22 million, which was partially offset by applying $8 million of previously recovered carryover funds. TEP has been approved to collect the remaining $14 million from retail customers through the DSM surcharge. Energy savings realized through the programs will count toward meeting the EE Standards and the associated lost revenue will be partially recovered through the Lost Fixed Cost Recovery (LFCR) mechanism.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In June 2016, TEP notified the ACC that it would not file a 2017 implementation plan and instead continue the 2016 level of recovery through the end of 2017. TEP plans to reduce its costs and incentive levels for certain programs in order to minimize any potential under-collected DSM balance at the end of 2017. TEP expects to file its 2018 implementation plan by August 2017.

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 \$5 million and \$11 million in the three and six months ended June 30, 2017, respectively, and \$4 million and \$9 million in the three and six months ended June 30, 2016, respectively. LFCR revenues are included in Retail Revenues on the Condensed Consolidated Statements of Income.

REGULATORY ASSETS AND LIABILITIES

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

(dollars in millions)	Remaining Recovery Period (years)	June 30, 2017	December 31, 2016
Regulatory Assets			
Pension and Other Postretirement Benefits (Note 7)	Various	$ 124	$ 128
Final Mine Reclamation and Retiree Health Care Costs (1)	20	30	27
Navajo Costs (2)	13	38	—
Income Taxes Recoverable through Future Rates	Various	30	29
Lost Fixed Cost Recovery	1	29	23
Property Tax Deferrals	1	23	23
Springerville Unit 1 Leasehold Improvements (3)	6	15	17
Sundt Coal Handling Facilities (4)	N/A	—	14
Other Regulatory Assets	Various	32	20
Total Regulatory Assets		321	281
Less Current Portion	1	67	56
Total Non-Current Regulatory Assets		$ 254	$ 225
Regulatory Liabilities			
Net Cost of Removal (5)	Various	$187	$270
Renewable Energy Standard	Various	38	32
Purchased Power and Fuel Adjustment Clause	1	25	38
Deferred Investment Tax Credits	Various	21	23
Other Regulatory Liabilities	Various	9	14
Total Regulatory Liabilities		280	377
Less Current Portion	1	66	76
Total Non-Current Regulatory Liabilities		$214	$301

(1) Includes 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 fully recover these costs through the PPFAC mechanism. The majority of final mine reclamation costs are expected to occur through 2037.

(2) As a result of the planned early retirement of Navajo, the NBV and other related costs were reclassified from Utility Plant, Net on the Condensed Consolidated Balance Sheets as of June 30, 2017. See Note 1 for additional

information related to the early retirement of Navajo.

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(3) Represents investments TEP made to ensure that the facilities continued to provide safe, reliable service to TEP's customers. TEP received ACC authorization to recover leasehold improvement costs at Springerville Unit 1 over a 10-year amortization period.

(4) The ACC authorized TEP to apply excess depreciation reserves against the unrecovered NBV in the 2017 Rate Order.

(5) Net Cost of Removal represents an estimate of the future cost of retirement net of salvage value. These are amounts collected through revenue for transmission, distribution, generation plant, and general and intangible plant which are not yet expended. As a result of the 2017 Rate Order, $87 million was transferred from Net Cost of Removal to Accumulated Depreciation and Amortization to reflect the impact of the revised depreciation study on the estimated cost of removal.

Regulatory assets are either being collected or are expected to be collected through Retail Rates. With the exception of the Navajo 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. With the exception of over-recovered PPFAC costs, 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 recording a liability and paying time-value refunds to the counterparties of these TSAs. In May 2017, the FERC informed TEP that the related investigation was closed. See Note 6 for additional information related to FERC compliance associated with these transmission contracts.

NOTE 3. ACCOUNTS RECEIVABLE

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

(in millions)	June 30, 2017	December 31, 2016
Customer	$ 92	$ 74
Due from Affiliates (Note 4)	7	9
Unbilled	61	34
Other	18	13
Allowance for Doubtful Accounts	(5)	(5)
Accounts Receivable, Net	$ 173	$ 125

NOTE 4. 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.

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)	June 30, 2017	December 31, 2016
Receivables from Related Parties		
UNS Electric	$ 5	$ 7
UNS Gas	2	2

Total Due from Related Parties	$	7	$	9
Payables to Related Parties				
SES	$	2	$	2
UNS Energy		1		—
Total Due to Related Parties	$	3	$	2

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(in millions)	Three Months Ended June 30, 2017	2016	Six Months Ended June 30, 2017	2016
Goods and Services Provided by TEP to Affiliates				
Transmission Revenues, UNS Electric [(1)]	$ 2	$ 2	$ 3	$ 3
Control Area Services, UNS Electric [(2)]	1	1	1	1
Common Costs, UNS Energy Affiliates [(3)]	4	4	8	7
Goods and Services Provided by Affiliates to TEP				
Supplemental Workforce, SES [(4)]	4	3	7	7
Corporate Services, UNS Energy [(5)]	1	2	3	4
Corporate Services, UNS Energy Affiliates [(6)]	1	2	2	2

(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 are 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 were $1 million and $2 million for the three and six months ended June 30, 2017, respectively, and $2 million and $3 million for the three and six months ended June 30, 2016, 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.

CONTRIBUTION FROM PARENT

UNS Energy made no equity contributions to TEP in the three and six months ended June 30, 2017 or 2016.

DIVIDENDS PAID TO PARENT

TEP did not declare or pay dividends to UNS Energy in the three and six months ended June 30, 2017 or 2016. On July 24, 2017, TEP declared a $35 million dividend to UNS Energy to be paid by July 28, 2017.

NOTE 5. 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 2016 Annual Report on Form 10-K, except as noted below.

CREDIT FACILITY

As of June 30, 2017, there was $250 million available under the revolving credit commitments and Letter of Credit (LOC) facility. As of July 27, 2017, TEP had $230 million available under its revolving credit commitments and LOC facility.

COVENANT COMPLIANCE

As of June 30, 2017, TEP was in compliance with the terms of its credit and long-term debt agreements.

NOTE 6. COMMITMENTS AND CONTINGENCIES

COMMITMENTS

There have been no significant changes to TEP's long-term commitments from those reported in its 2016 Annual Report on Form 10-K.

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 condensed consolidated 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 Four Corners Generating Station

Endangered Species Act

On April 20, 2016, several environmental groups filed a lawsuit in the U.S. District Court for the District of Arizona against the Office of Surface Mining (OSM) and other federal agencies under the Endangered Species Act (ESA) alleging that the OSM's reliance on the Biological Opinion and Incidental Take Statement prepared in connection with a federal environmental review were not in accordance with applicable law. The environmental review was undertaken as part of the U.S. Department of the Interior's review process necessary to allow for the effectiveness of lease amendments and related rights-of-way renewals for Four Corners. This review process also required separate environmental impact evaluations under the National Environmental Policy Act (NEPA) and culminated in the issuance of a Record of Decision justifying the agency action extending the life of Four Corners and the adjacent Navajo Mine. In addition, the lawsuit alleges that these federal agencies violated both the ESA and the NEPA in providing the federal approvals necessary to extend operations at Four Corners and Navajo Mine past July 6, 2016. The lawsuit seeks various forms of relief, including a finding that the federal defendants violated the ESA and the NEPA by issuing the Record of Decision, setting aside and remanding the Biological Opinion and Record of Decision, and enjoining the federal defendants from authorizing any elements of the Four Corners and Navajo Mine pending compliance with NEPA. In July 2016, the defendants answered the complaint and Arizona Public Service Company (APS), the operator of Four Corners, filed a motion to intervene in this matter. APS' motion was granted in August 2016. In September 2016, Navajo Transitional Energy Company, LLC (NTEC), the company that owns the Navajo Mine, filed a motion to intervene for the purpose of dismissing the lawsuit based on NTEC's tribal sovereign immunity. Because the court has placed a stay on all litigation deadlines pending its decision regarding NTEC's motion to dismiss, the schedule for briefing and the anticipated timeline for completion of this litigation will likely be extended. TEP cannot currently predict the outcome of this matter or the range of its potential impact.

Claims Related to San Juan Generating Station

WildEarth Guardians

In February 2013, WildEarth Guardians (WEG) filed a Petition for Review in the U.S. District Court for the District of Colorado against the OSM challenging federal administrative decisions issued at various times from 2007 through 2012. In its petition, WEG challenges several unrelated mining plan modification approvals, which were each separately approved by the OSM. Of the claims for relief in the WEG Petition, two concern San Juan Coal Company's (SJCC) San Juan mine. WEG's allegations concerning the San Juan mine arise from the OSM administrative actions in 2008. WEG alleges various NEPA violations against the OSM, including, but not limited to, the OSM's alleged failure to provide requisite public notice and participation, alleged failure to analyze certain environmental impacts, and alleged reliance on outdated and insufficient documents. WEG's petition seeks various forms of relief, including a finding that the federal defendants violated the NEPA by approving the mine plans, voiding, reversing, and remanding the various mining modification approvals, enjoining the federal defendants from re-issuing the mining plan approvals for the mines until compliance with the NEPA has been demonstrated, and enjoining operations at the affected mines.

SJCC intervened in this matter. SJCC 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 proceeding. On July 18, 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 federal defendants’ motion for remand to conduct further environmental analysis and complete an EIS by August 31, 2019. The order provided that the OSM’s decision approving the mining plan will remain in effect during this process. The order further provides that if the EIS is not completed

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by August 31, 2019, then an order vacating the approved mine plan will become immediately effective, absent further court order. TEP cannot currently predict the outcome of this matter or the range of its potential impact.

Mine Reclamation at Generating Facilities Not Operated by TEP

TEP pays ongoing reclamation mine 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 $61 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 $28 million as of June 30, 2017 and $26 million as of December 31, 2016.

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.

FERC Compliance

In 2015 and 2016, TEP self-reported to the FERC Office of Enforcement (OE) that the Company had not timely filed certain FERC-jurisdictional agreements. TEP conducted comprehensive internal reviews of its compliance with the FERC filing requirements (Compliance Reviews) and made compliance filings with the FERC Office of Energy Market Regulation. This included the filing of several TSAs entered into between 2003 and 2015 that contained certain deviations from TEP's standard service agreement form.

In 2016, the FERC issued orders related to the late-filed TSAs which directed TEP to issue time-value refunds to the counterparties to these TSAs (FERC Refund Orders). As a result of the FERC Refund Orders and ongoing discussions with the OE, TEP recorded a liability for the time-value refunds with a corresponding offset in revenues on its financial statements in 2016. For the six months ended June 30, 2016, Wholesale Revenues on the Condensed Consolidated Statements of Income reflected $13 million related to the time-value refunds. As of December 31, 2016, Current Liabilities—Other on the Condensed Consolidated Balance Sheets reflected $5 million related to the time-value refunds.

In June 2016, to preserve its rights, TEP petitioned the U.S. Court of Appeals for the District of Columbia Circuit to review the FERC Refund Orders. In January 2017, TEP and one of the TSA counterparties entered into a settlement agreement regarding the FERC Refund Orders. In accordance with the agreement, the counterparty paid TEP $8 million, which TEP recorded in Other Income on the Condensed Consolidated Statements of Income and dismissed the appeal with prejudice in January 2017.

In May 2017, the FERC informed TEP that: (i) no further enforcement actions were necessary regarding the late-filed TSAs; and (ii) the related investigation was closed. As management no longer believed a loss was probable, TEP reversed the $5 million remaining balance related to potential time-value refunds in Current Liabilities—Other on the Condensed Consolidated Balance Sheets, offsetting Wholesale Revenues on the Condensed Consolidated Statements of Income.

Performance Guarantees

TEP has joint participation agreements with participants at Navajo, San Juan, Four Corners, and with 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, the non-defaulting participants have agreed to bear a 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 June 30, 2017, 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.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 condensed consolidated 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.

NOTE 7. EMPLOYEE BENEFIT PLANS
Net periodic benefit cost includes the following components:

	Pension Benefits		Other Postretirement Benefits	
	Three Months Ended June 30,			
(in millions)	2017	2016	2017	2016
Service Cost	$3	$ 3	$ 1	$ 1
Interest Cost	4	3	1	1
Expected Return on Plan Assets	(6)	(6)	—	(1)
Amortization of Net Loss	2	2	—	—
Net Periodic Benefit Cost	$3	$ 2	$ 2	$ 1

	Pension Benefits		Other Postretirement Benefits	
	Six Months Ended June 30,			
(in millions)	2017	2016	2017	2016
Service Cost	$6	$ 6	$ 2	$ 2
Interest Cost	8	7	1	1
Expected Return on Plan Assets	(12)	(12)	—	(1)
Amortization of Net Loss	4	4	—	—
Net Periodic Benefit Cost	$6	$ 5	$ 3	$ 2

CONTRIBUTIONS
TEP contributed $3 million during the six months ended June 30, 2017 to the pension plans and expects to contribute a total of $9 million in 2017.

NOTE 8. SUPPLEMENTAL CASH FLOW INFORMATION
NON-CASH TRANSACTIONS
Other significant non-cash investing and financing activities that affected recognized assets and liabilities but did not result in cash receipts or payments were as follows:

	Six Months Ended June 30,

(in millions)	2017	2016
Net Cost of Removal [1]	$ 82	$ —
Accrued Capital Expenditures	17	11

(1) Non-cash Net Cost of Removal represents an accrual for future cost of retirement net of salvage values that does not impact earnings. In the 2017 Rate Order, the ACC authorized a new depreciation study for TEP modifying its depreciation reserves and rates. See Note 2 for additional information.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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. These assets and liabilities are 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)	June 30, 2017			
Assets				
Cash Equivalents(1)	$3	$ —	$ —	$ 3
Restricted Cash(1)	8	—	—	8
Energy Derivative Contracts, Regulatory Recovery(2)	—	1	1	2
Energy Derivative Contracts, No Regulatory Recovery(2)	—	—	4	4
Total Assets	11	1	5	17
Liabilities				
Energy Derivative Contracts, Regulatory Recovery(2)	—	(7)	(1)	(8)
Interest Rate Swap(3)	—	(1)	—	(1)
Total Liabilities	—	(8)	(1)	(9)
Total Assets (Liabilities), Net	$11	$ (7)	$ 4	$ 8
(in millions)	December 31, 2016			
Assets				
Cash Equivalents(1)	$23	$—	$—	$23
Restricted Cash(1)	7	—	—	7
Energy Derivative Contracts, Regulatory Recovery(2)	—	3	—	3
Energy Derivative Contracts, No Regulatory Recovery(2)	—	—	2	2
Total Assets	30	3	2	35
Liabilities				