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TUCSON ELECTRIC POWER CO  
Form 10-Q/A  
August 24, 2004

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q/A  
AMENDMENT NO. 1

(Mark One)

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

For The Quarterly Period Ended March 31, 2004

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

Indicate by check mark whether each 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  No   
--- ---

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

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

At May 4, 2004, 34,143,167 shares of UniSource Energy Corporation's Common Stock, no par value (the only class of Common Stock), were outstanding.

At May 4, 2004, 32,139,555 shares of Tucson Electric Power Company's common stock, no par value, were outstanding, of which 32,139,434 were held by UniSource Energy Corporation.

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This combined Form 10-Q is separately filed by UniSource Energy Corporation and Tucson Electric Power Company. Information contained in this document relating to Tucson Electric Power Company is filed by UniSource Energy Corporation and separately by Tucson Electric Power Company on its own behalf. Tucson Electric Power Company makes no representation as to information relating to UniSource Energy Corporation or its subsidiaries, except as it may relate to Tucson Electric Power Company.

## EXPLANATORY NOTE

This Amendment No. 1 to the Quarterly Report on Form 10-Q for UniSource Energy Corporation and Tucson Electric Power Company (TEP) for the quarterly period ended March 31, 2004 is being filed for the purpose of amending and revising Part I, Item 1 - Financial Statements, and Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations, and Part II, Item 4 - Controls and Procedures and Item 6 - Exhibits and Reports on Form 8-K. This Form 10-Q/A is being filed in order to retroactively apply a change in unbilled revenue estimation. While not amended, the remaining items of the Form 10-Q are included for convenience.

TEP and UniSource Energy Services, Inc. (UES) record utility operating revenues when services are provided or commodities are delivered to customers. Operating revenues include unbilled revenues which are earned (service has been provided) but not billed by the end of an accounting period. During the second quarter of 2004, we determined that TEP's existing methodology for estimating unbilled revenues resulted in misreporting of revenues in prior periods. In general, the misreporting resulted in an under reporting of revenues, however, for the three months ended March 31, 2004 and 2003, the misreporting resulted in an over reporting of revenues. As a result, TEP changed the methodology for estimating unbilled revenues and restated prior year financial statements to give effect to the change and correct the reporting of revenues in those periods.

As described in Note 18, Change in Unbilled Revenue Estimation Methodology at TEP, the financial information for all periods presented reflects the revised unbilled revenue estimation methodology.

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### DEFINITIONS

The abbreviations and acronyms used in the 2004 First Quarter 10-Q are defined below:

---

ACC.....	Arizona Corporation Commission.
ACC Holding Company Order.....	The order approved by the ACC in November 1997 allowing TEP to form a holding company.
AHMSA.....	Altos Hornos de Mexico, S.A. de C.V. AHMSA owns 50% of Sabinas.
AMT.....	Alternative Minimum Tax.
Btu.....	British thermal unit(s).
Capacity.....	The ability to produce power; the most power a unit can produce or the maximum that can be taken under a contract; measured in MWs.
CISO.....	California Independent System Operator.
Citizens.....	Citizens Communications Company.
Citizens Settlement Agreement....	An agreement with the ACC Staff dated April 1, 2003, addressing rate case and financing issues in the acquisition by UniSource Energy of the Citizens' Arizona gas and electric assets.
Common Stock.....	UniSource Energy's common stock, without par value.
Company or UniSource Energy.....	UniSource Energy Corporation.
CPX.....	California Power Exchange.
Credit Agreement.....	Credit Agreement between TEP and a syndicate of lenders, dated as of March 25, 2004.

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Emissions Allowance(s).....	An allowance issued by the Environmental Protection Agency which permits emission of one ton of sulfur dioxide or one ton of nitrogen oxide. These allowances can be bought and sold.
Energy.....	The amount of power produced over a given period of time; measured in MWh.
FAS 71.....	Statement of Financial Accounting Standards No. 71: Accounting for the Effects of Certain Types of Regulation.
FAS 132.....	Statement of Financial Accounting Standards No. 132: Employers' Disclosures about Pensions and Other Postretirement Benefits.
FAS 133.....	Statement of Financial Accounting Standards No. 133: Accounting for Derivative Instruments and Hedging Activities.
FAS 143.....	Statement of Financial Accounting Standards No. 143: Accounting for Asset Retirement Obligations.
FAS 149.....	Statement of Financial Accounting Standards No. 149: Amendment of Statement 133 on Derivative Instruments and Hedging Activities.
FERC.....	Federal Energy Regulatory Commission.
First Collateral Trust Bonds.....	Bonds issued under the Indenture of Trust, dated as of August 1, 1998, of TEP to the Bank of New York, successor trustee.
First Mortgage Bonds.....	First mortgage bonds issued under the Indenture dated as of April 1, 1941, of TEP to JPMorgan Chase Bank, successor trustee, as supplemented and amended.
Four Corners.....	Four Corners Generating Station.
GAAP.....	Generally Accepted Accounting Principles.
Global Solar.....	Global Solar Energy, Inc., a company that develops and manufactures thin-film photovoltaic cells. Millennium owns 99% of Global Solar.
Haddington.....	Haddington Energy Partners II, LP, a limited partnership that funds energy-related investments
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.
IDBs.....	Industrial development revenue or pollution control revenue bonds.
IPS.....	Infinite Power Solutions, Inc., a company that develops thin-film batteries. Millennium owns 72% of IPS.
IRS.....	Internal Revenue Service.
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ISO.....	Independent System Operator.
ITN.....	ITN Energy Systems, Inc. was formed to provide research, development, and other services. Millennium exchanged its

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	ownership of ITN for increased ownership of Global Solar and currently owns no interest in ITN.
ITC.....	Investment tax credit.
kWh.....	Kilowatt-hour(s).
kV.....	Kilovolt(s).
LIBOR.....	London Interbank Offered Rate.
LOC.....	Letter of Credit.
MEG.....	Millennium Environmental Group, Inc., a wholly-owned subsidiary of Millennium, which manages and trades emission allowances, coal, and related financial instruments.
MicroSat.....	MicroSat Systems, Inc. is a company formed to develop and commercialize small-scale satellites. Millennium currently owns 35%.
Millennium.....	Millennium Energy Holdings, Inc., a wholly-owned subsidiary of UniSource Energy.
Mimosa.....	Minerales de Monclova, S.A. de C.V., an owner of coal and associated gas reserves and a supplier of metallurgical coal to the steel industry and thermal coal to the Mexican electricity commission. Sabinas owns 19.5% of Mimosa.
MMBtus.....	Million British Thermal Units.
MW.....	Megawatt(s).
MWh.....	Megawatt-hour(s).
Navajo.....	Navajo Generating Station.
NOL.....	Net Operating Loss carryback or carryforward for income tax purposes.
PGA.....	Purchased Gas Adjuster, a retail rate mechanism designed to recover the cost of gas purchased for retail gas customers.
PNM.....	Public Service Company of New Mexico.
Powertrusion.....	POWERTRUSION International, Inc., a company owned 77% by Millennium, which manufactures lightweight utility poles.
PPFAC.....	Purchased Power and Fuel Adjustment Clause.
PWCC.....	Pinnacle West Capital Corporation.
Revolving Credit Facility.....	\$60 million revolving credit facility entered into under the Credit Agreement between a syndicate of banks and TEP.
RTO.....	Regional Transmission Organization.
Rules.....	Retail Electric Competition Rules.
Sabinas.....	Carboelectrica Sabinas, S. de R.L.de C.V., a Mexican limited liability company. Millennium owns 50% of Sabinas.
Saguaro Utility.....	An Arizona limited partnership, whose general partner is Sage Mountain, L.L.C. and whose limited partners include investment funds affiliated with Kohlberg Kravis Roberts & Co., L.P., J.P. Morgan Partners, L.L.C. and Wachovia Capital Partners.
San Juan.....	San Juan Generating Station.
Second Mortgage Bonds.....	TEP's second mortgage bonds issued under the Indenture of Mortgage and Deed of

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	Trust, dated as of December 1, 1992, of TEP to the Bank of New York, successor trustee, as supplemented.
SCE.....	Southern California Edison Company.
SES.....	Southwest Energy Solutions, Inc., a wholly-owned subsidiary of Millennium.
Springerville.....	Springerville Generating Station.
Springerville Coal Handling Facilities Leases.....	Leveraged lease arrangements relating to the coal handling facilities serving Springerville.
Springerville Common Facilities.....	Facilities at Springerville used in common with Springerville Unit 1 and Springerville Unit 2.
Springerville Common Facilities Leases.....	Leveraged lease arrangements relating to an undivided one-half interest in certain Springerville Common Facilities.

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Springerville Unit 1.....	Unit 1 of the Springerville Generating Station.
Springerville Unit 1 Lease.....	Leveraged lease arrangement relating to Springerville Unit 1 and an undivided one-half interest in certain Springerville Common Facilities.
Springerville Unit 2.....	Unit 2 of the Springerville Generating Station.
Sundt Generating Station.....	H. Wilson Sundt Generating Station (formerly known as the Irvington Generating Station).
Sundt Lease.....	The leveraged lease arrangement relating to Sundt Unit 4.
TEP.....	Tucson Electric Power Company, the principal subsidiary of UniSource Energy.
TEP Settlement Agreement.....	TEP's Settlement Agreement approved by the ACC in November 1999 that provided for electric retail competition and transition asset recovery.
Therm.....	A unit of heating value equivalent to 100,000 British thermal units (Btu).
Tri-State.....	Tri-State Generation and Transmission Association.
TruePricing.....	TruePricing, Inc., a start-up company established to market energy related products.
UED.....	UniSource Energy Development Company, a wholly-owned subsidiary of UniSource Energy, which engages in developing generation resources and other project development services and related activities.
UES.....	UniSource Energy Services, Inc., an intermediate holding company established to own the operating companies (UNS Gas

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	and UNS Electric) which acquired the Citizens Arizona gas and electric utility assets.
UniSource Energy.....	UniSource Energy Corporation.
UNS Electric.....	UNS Electric, Inc., a wholly-owned subsidiary of UES, which acquired the Citizens Arizona electric utility assets.
UNS Gas.....	UNS Gas, Inc., a wholly-owned subsidiary of UES, which acquired the Citizens Arizona gas utility assets.
WestConnect.....	The proposed for-profit RTO in which TEP is a participant.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of  
UniSource Energy Corporation and  
to the Board of Directors of  
Tucson Electric Power Company

We have reviewed the accompanying condensed consolidated balance sheet of UniSource Energy Corporation and its subsidiaries (the Company) and Tucson Electric Power Company and its subsidiaries (TEP) as of March 31, 2004 and the related condensed consolidated statements of income and of cash flows for each of the three-month periods ended March 31, 2004 and 2003 and the condensed consolidated statement of changes in stockholders' equity for the three-month period ended March 31, 2004. These interim financial statements are the responsibility of the Company's and TEP's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

As discussed in Note 18 to the condensed consolidated interim financial statements, the Company and TEP have restated their financial statements for unbilled revenues as of March 31, 2004 and for the three-month periods ended March 31, 2004 and 2003.

We previously audited in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet and statement of capitalization of the Company and TEP as of December 31, 2003, and the related consolidated statements of income, changes in stockholders' equity, and of cash flows for the year then ended (not presented herein), and in our



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report dated February 20, 2004, except as to the restatement of unbilled revenue described in Note 22, as to which the date is August 19, 2004, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheets as of December 31, 2003, are fairly stated in all material respects in relation to the consolidated balance sheets from which they have been derived.

PricewaterhouseCoopers LLP

Los Angeles, California

May 3, 2004, except for Note 18, as to which the date is August 19, 2004

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### PART I - FINANCIAL INFORMATION

#### ITEM 1. FINANCIAL STATEMENTS

##### UNISOURCE ENERGY CORPORATION

COMPARATIVE CONDENSED CONSOLIDATED STATEMENTS OF INCOME (Restated See Note 18)

	Three Months March 2004* (Unaudited)
	-Thousands of
<hr/>	
Operating Revenues	
Electric Retail Sales	\$ 174,363
Electric Wholesale Sales	41,700
Gas Revenue	48,801
Other Revenues	5,220
<hr/>	
Total Operating Revenues	270,084
<hr/>	
Operating Expenses	
Fuel	47,449
Purchased Energy	56,468
Other Operations and Maintenance	66,613
Depreciation and Amortization	35,136
Amortization of Transition Recovery Asset	8,597
Taxes Other Than Income Taxes	13,111
<hr/>	
Total Operating Expenses	227,374
<hr/>	
Operating Income	42,710
<hr/>	
Other Income (Deductions)	
Interest Income	4,869
Other Income	8,715
Other Expense	(1,016)
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Total Other Income (Deductions)	12,568
-----	
Interest Expense	
Long-Term Debt	23,118
Interest on Capital Leases	20,044
Other Interest Expense, Net of Amounts Capitalized	(214)
-----	
Total Interest Expense	42,948
-----	
Income (Loss) Before Income Taxes and Cumulative Effect of Accounting Change	12,330
Income Tax Expense (Benefit)	5,909
-----	
Income (Loss) Before Cumulative Effect of Accounting Change	6,421
Cumulative Effect of Accounting Change - Net of Tax	-
-----	
Net Income	\$ 6,421
=====	
Weighted-average Shares of Common Stock Outstanding (000)	34,185
=====	
Basic Earnings per Share	
Income (Loss) Before Cumulative Effect of Accounting Change	\$ 0.19
Cumulative Effect of Accounting Change - Net of Tax	-
-----	
Net Income	\$ 0.19
=====	
Diluted Earnings per Share	
Income (Loss) Before Cumulative Effect of Accounting Change	\$ 0.18
Cumulative Effect of Accounting Change - Net of Tax	-
-----	
Net Income	\$ 0.18
=====	
Dividends Paid per Share	\$ 0.16
=====	

UNISOURCE ENERGY CORPORATION  
COMPARATIVE CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Three Month  
March  
2004  
(Unaudited)

-----  
-Thousands of

Cash Flows from Operating Activities

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Cash Receipts from Electric Retail Sales	\$ 200,489
Cash Receipts from Electric Wholesale Sales	56,327
Cash Receipts from Gas Sales	56,570
Other Cash Receipts	2,175
MEG Cash Receipts from Trading Activity	34,357
Interest Received	10,504
Income Tax Refunds Received	286
Performance Deposits	(7,052)
Fuel Costs Paid	(46,073)
Purchased Energy Costs Paid	(75,264)
Wages Paid, Net of Amounts Capitalized	(25,051)
Payment of Other Operations and Maintenance Costs	(37,324)
MEG Cash Payments for Trading Activity	(28,278)
Capital Lease Interest Paid	(40,308)
Taxes Paid, Net of Amounts Capitalized	(22,336)
Interest Paid, Net of Amounts Capitalized	(30,135)
Income Taxes Paid	(7,000)
Other	553
<hr/>	
Net Cash Flows - Operating Activities	42,440
<hr/>	
Cash Flows from Investing Activities	
Capital Expenditures	(31,370)
Investment in and Loans to Equity Investees	(361)
Proceeds from Investment in Springerville Lease Debt and Equity	8,054
Payments for Investment in Springerville Lease Debt and Equity	(4,499)
Other	(4)
<hr/>	
Net Cash Flows - Investing Activities	(28,180)
<hr/>	
Cash Flows from Financing Activities	
Proceeds from Borrowings under Revolving Credit Facility	20,000
Payments on Borrowings under the Revolving Credit Facility	(20,000)
Proceeds from Issuance of Short-Term Debt	-
Repayments of Short-Term Debt	-
Repayments of Long-Term Debt	(1,232)
Payment of Debt Issue Costs	(8,959)
Payments on Capital Lease Obligations	(43,632)
Common Stock Dividends Paid	(5,439)
Other	4,961
<hr/>	
Net Cash Flows - Financing Activities	(54,301)
<hr/>	
Net Decrease in Cash and Cash Equivalents	(40,041)
Cash and Cash Equivalents, Beginning of Year	101,266
<hr/>	
Cash and Cash Equivalents, End of Period	\$ 61,225
<hr/>	

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COMPARATIVE CONDENSED CONSOLIDATED BALANCE SHEETS (Restated see Note 18)

	March 31, 2004*	(Unaudited)
- Thousands		
<b>ASSETS</b>		
Utility Plant		
Plant in Service	\$ 2,909,618	
Utility Plant under Capital Leases	748,239	
Construction Work in Progress	123,864	
Total Utility Plant	3,781,721	
Less Accumulated Depreciation and Amortization	(1,289,149)	
Less Accumulated Amortization of Capital Lease Assets	(428,504)	
Total Utility Plant - Net	2,064,068	
Investments and Other Property		
Investments in Lease Debt and Equity	175,007	
Other	115,864	
Total Investments and Other Property	290,871	
Current Assets		
Cash and Cash Equivalents	61,225	
Trade Accounts Receivable	94,038	
Unbilled Accounts Receivable	41,332	
Allowance for Doubtful Accounts	(11,757)	
Materials and Fuel Inventory	58,920	
Trading Assets	49,295	
Current Regulatory Assets	9,762	
Income Taxes Receivable	3,561	
Deferred Income Taxes - Current	10,120	
Interest Receivable - Current	6,195	
Other	21,975	
Total Current Assets	344,666	
Regulatory and Other Assets		
Transition Recovery Asset	265,585	
Income Taxes Recoverable Through Future Revenues	48,543	
Other Regulatory Assets	12,684	
Other Assets	53,030	
Total Regulatory and Other Assets	379,842	
Total Assets	\$ 3,079,447	
<b>CAPITALIZATION AND OTHER LIABILITIES</b>		
Capitalization		
Common Stock Equity	\$ 563,480	
Capital Lease Obligations	719,870	
Long-Term Debt	1,285,095	

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Total Capitalization	2,568,445
-----	
Current Liabilities	
Current Obligations under Capital Leases	54,848
Current Maturities of Long-Term Debt	1,725
Accounts Payable	53,573
Interest Accrued	26,989
Trading Liabilities	43,964
Taxes Accrued	47,905
Accrued Employee Expenses	13,958
Other	18,996
-----	
Total Current Liabilities	261,958
-----	
Deferred Credits and Other Liabilities	
Deferred Income Taxes - Noncurrent	106,035
Regulatory Liability - Net Cost of Removal for Interim Retirements	63,140
Other	79,869
-----	
Total Deferred Credits and Other Liabilities	249,044
-----	
Commitments and Contingencies (Note 9)	
-----	
Total Capitalization and Other Liabilities	\$ 3,079,447
=====	

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UNISOURCE ENERGY CORPORATION  
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY (Restated See Note 6)

	Common Shares Outstanding*	Common Stock	Accumulated Earnings (Deficit)*
			(Unaudited) - Thousands of Dollars
Balances at December 31, 2003	33,788	\$ 668,022	\$ (109,706)
-----			
Comprehensive Income:			
2004 Year-to-Date Net Income		-	6,421
Unrealized Gain on Cash Flow Hedges (net of \$574,000 income tax expense)		-	-
Total Comprehensive Income			
Dividends Declared		-	(5,439)

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Shares Issued under Stock Compensation Plans	64	1,307	-
Shares Distributed by Deferred Compensation Trust	-	2	-
Shares Issued for Stock Options	204	3,813	-
Other	-	28	-
-----			
Balances at March 31, 2004	34,056	\$ 673,172	\$ (108,724)
=====			

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TUCSON ELECTRIC POWER COMPANY  
 COMPARATIVE CONDENSED CONSOLIDATED STATEMENTS OF INCOME (Restated See Note 18)

			Three M M 2004* (U
			-Thousan
-----			
Operating Revenues			
Electric Retail Sales		\$ 143,176	
Electric Wholesale Sales		41,649	
Other Revenues		2,149	
-----			
Total Operating Revenues		186,974	
-----			
Operating Expenses			
Fuel		47,449	
Purchased Power		6,252	
Other Operations and Maintenance		47,829	
Depreciation and Amortization		30,413	
Amortization of Transition Recovery Asset		8,597	
Taxes Other Than Income Taxes		10,746	
-----			
Total Operating Expenses		151,286	
-----			
Operating Income		35,688	
-----			
Other Income (Deductions)			
Interest Income		4,861	
Interest Income - Note Receivable from UniSource Energy		2,320	
Other Income		1,164	
Other Expense		(936)	
-----			
Total Other Income (Deductions)		7,409	
-----			
Interest Expense			
Long-Term Debt		20,381	
Interest on Capital Leases		20,037	
Other Interest Expense, Net of Amounts Capitalized		(189)	

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Total Interest Expense	40,229
Income (Loss) Before Income Taxes and Cumulative Effect of Accounting Change	2,868
Income Tax Expense (Benefit)	2,074
Income (Loss) Before Cumulative Effect of Accounting Change	794
Cumulative Effect of Accounting Change - Net of Tax	-
Net Income	\$ 794

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TUCSON ELECTRIC POWER COMPANY  
COMPARATIVE CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Month March 2004 (Unaudited)
	-Thousands of
Cash Flows from Operating Activities	
Cash Receipts from Electric Retail Sales	\$ 165,683
Cash Receipts from Electric Wholesale Sales	56,258
Interest Received	10,452
Fuel Costs Paid	(46,073)
Purchased Power Costs Paid	(22,380)
Wages Paid, Net of Amounts Capitalized	(17,985)
Payment of Other Operations and Maintenance Costs	(28,281)
Capital Lease Interest Paid	(40,304)
Taxes Paid, Net of Amounts Capitalized	(13,841)
Interest Paid, Net of Amounts Capitalized	(24,949)
Income Taxes Refunds Received	286
Income Taxes Paid	(5,000)
Other	260
Net Cash Flows - Operating Activities	34,126
Cash Flows from Investing Activities	
Capital Expenditures	(22,956)
Proceeds from Investment in Springerville Lease Debt and Equity	8,054
Payments for Investment in Springerville Lease Debt and Equity	(4,499)
Other	-
Net Cash Flows - Investing Activities	(19,401)

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Cash Flows from Financing Activities	
Proceeds from Borrowings under Revolving Credit Facility	20,000
Payments on Revolving Credit Facility	(20,000)
Repayments of Long-Term Debt	(1,225)
Payments on Capital Lease Obligations	(43,599)
Payment of Debt Issue Costs	(8,583)
Other	4,256
-----	
Net Cash Flows - Financing Activities	(49,151)
-----	
Net Decrease in Cash and Cash Equivalents	(34,426)
Cash and Cash Equivalents, Beginning of Year	65,262
-----	
Cash and Cash Equivalents, End of Period	\$ 30,836
=====	

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TUCSON ELECTRIC POWER COMPANY  
 COMPARATIVE CONDENSED CONSOLIDATED BALANCE SHEETS (Restated See Note 18)

	March 31, 2008
	-----
	- Tho
ASSETS	
Utility Plant	
Plant in Service	\$ 2,680,04
Utility Plant under Capital Leases	747,53
Construction Work in Progress	103,32
-----	
Total Utility Plant	3,530,90
Less Accumulated Depreciation and Amortization	(1,280,09)
Less Accumulated Amortization of Capital Lease Assets	(428,44)
-----	
Total Utility Plant - Net	1,822,36
-----	
Investments and Other Property	
Investments in Lease Debt and Equity	175,00
Other	41,27
-----	
Total Investments and Other Property	216,28
-----	
Note Receivable from UniSource Energy	72,45
-----	
Current Assets	
Cash and Cash Equivalents	30,83
Trade Accounts Receivable	61,81
Unbilled Accounts Receivable	26,76



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Allowance for Doubtful Accounts	(10,94)
Intercompany Accounts Receivable	9,34
Materials and Fuel Inventory	49,85
Current Regulatory Assets	9,54
Income Taxes Receivable	3,94
Deferred Income Taxes - Current	11,34
Interest Receivable - Current	6,19
Other	9,70
<hr/>	
Total Current Assets	208,40
<hr/>	
Regulatory and Other Assets	
Transition Recovery Asset	265,58
Income Taxes Recoverable Through Future Revenues	48,54
Other Regulatory Assets	12,34
Other Assets	49,78
<hr/>	
Total Regulatory and Other Assets	376,26
<hr/>	
Total Assets	\$ 2,695,77
<hr/>	
CAPITALIZATION AND OTHER LIABILITIES	
Capitalization	
Common Stock Equity	\$ 409,22
Capital Lease Obligations	719,26
Long-Term Debt	1,125,09
<hr/>	
Total Capitalization	2,253,58
<hr/>	
Current Liabilities	
Current Obligations under Capital Leases	54,71
Current Maturities of Long-Term Debt	1,72
Accounts Payable	30,03
Intercompany Accounts Payable	7,44
Interest Accrued	25,55
Taxes Accrued	32,12
Accrued Employee Expenses	13,03
Other	10,65
<hr/>	
Total Current Liabilities	175,28
<hr/>	
Deferred Credits and Other Liabilities	
Deferred Income Taxes - Noncurrent	137,35
Regulatory Liability - Net Cost of Removal for Interim Retirements	62,18
Other	67,36
<hr/>	
Total Deferred Credits and Other Liabilities	266,90
<hr/>	
Commitments and Contingencies (Note 9)	
<hr/>	
Total Capitalization and Other Liabilities	\$ 2,695,77
<hr/>	

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TUCSON ELECTRIC POWER COMPANY  
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY (Restated See Note 18)

	Common Stock*	Capital Stock Expense	Accumulated Earnings (Deficit)*
			(Unaudited) - Thousands of Dollars
Balances at December 31, 2003	\$ 655,534	\$ (6,357)	\$ (241,279)
Comprehensive Income:			
2004 Year-to-Date Net Income	-	-	794
Unrealized Gain on Cash Flow Hedges (net of \$574,000 income tax expense)	-	-	-
Total Comprehensive Income			
Capital Contribution from UniSource Energy	1,500	-	-
Balances at March 31, 2004	\$ 657,034	\$ (6,357)	\$ (240,485)

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED

NOTE 1. NATURE OF OPERATIONS, BASIS OF ACCOUNTING PRESENTATION AND EQUITY-BASED COMPENSATION

UniSource Energy Corporation (UniSource Energy) is an exempt holding company under the Public Utility Holding Company Act of 1935. UniSource Energy has no significant operations of its own, but owns 99.9% of the common stock of Tucson Electric Power Company (TEP) and all of the common stock of UniSource Energy Services, Inc. (UES), Millennium Energy Holdings, Inc. (Millennium) and UniSource Energy Development Company (UED).

TEP, a regulated public utility incorporated in Arizona since 1963, is UniSource Energy's largest operating subsidiary and represented approximately 85% of UniSource Energy's assets as of March 31, 2004. TEP generates, transmits and distributes electricity. TEP serves approximately 369,000 retail electric customers in a 1,155 square mile area in Pima and Cochise counties in Southern

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Arizona. TEP also sells electricity to other utilities and power marketing entities primarily located in the western U.S.

UES has no significant operations of its own, but owns all of the common stock of UNS Gas, Inc. (UNS Gas) and UNS Electric, Inc. (UNS Electric). On August 11, 2003, UniSource Energy completed the purchase of the Arizona gas and electric system assets from Citizens Communications Company (Citizens) and established two new operating companies, UNS Gas and UNS Electric, to acquire these assets, as well as an intermediate holding company, UES, to hold the common stock of UNS Gas and UNS Electric. The operating results of UNS Gas, UNS Electric, and UES have been included in UniSource Energy's consolidated financial statements since the acquisition date. UNS Electric procures, transmits and distributes electricity to approximately 82,000 retail electric customers in the Mohave county of Northern Arizona and the Santa Cruz county of Southern Arizona. UNS Gas procures, transports and distributes natural gas to approximately 129,000 customers in Mohave, Yavapai, Coconino, and Navajo counties in Northern Arizona and Santa Cruz county in Southern Arizona.

Millennium's unregulated businesses are described in Note 8 and UED's services are described in Note 7.

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

The accompanying quarterly financial statements of UniSource Energy and TEP are unaudited but reflect all normal recurring accruals and other adjustments which we believe are necessary for a fair presentation of the results for the interim periods presented. These financial statements are presented in accordance with the Securities and Exchange Commission's (SEC) interim reporting requirements which do not include all the disclosures required by accounting principles generally accepted in the United States of America (GAAP) for audited annual financial statements. The year-end condensed balance sheet data was derived from audited financial statements, but does not include disclosures required by GAAP for audited annual financial statements. This quarterly report should be reviewed in conjunction with UniSource Energy and TEP's 2003 Annual Report on Form 10-K.

Weather, among other factors, causes seasonal fluctuations in TEP and UES' sales; therefore, quarterly results are not indicative of annual operating results. UniSource Energy and TEP have made minor reclassifications to the prior year financial statements for comparative purposes. These reclassifications had no effect on net income.

### EQUITY-BASED COMPENSATION - (Restated - See Note 18)

UniSource Energy has two equity-based compensation plans, the 1994 Outside Director Stock Option Plan (Directors' Plan) and the 1994 Omnibus Stock and Incentive Plan (Omnibus Plan). See Note 13. We account for those plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and related interpretations.

Our stock options are granted with an exercise price equal to the market value of the stock at the date of the grant. Accordingly, no compensation expense is recorded for these awards. However, compensation expense is recognized for restricted stock, stock unit and performance share awards over the performance/vesting period.

The following table illustrates the effect on UniSource Energy's net income and earnings per share and TEP's net income as if we had applied the fair value recognition provisions of Statement of Financial Accounting

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

Standards No. 123, Accounting for Stock-Based Compensation, to all equity-based employee compensation awards:

UniSource Energy:

	Three Months Ended 2004	
	-Thousands of Dollars (except per share)	
Net Income - As Reported	\$	6,421
Add: Equity-based compensation expense included in reported net income, net of related tax effects		1,243
Deduct: Total equity-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(1,866)
Pro Forma Net Income	\$	5,798
Basic Earnings per Share:		
As Reported		\$0.19
Pro Forma		\$0.17
Diluted Earnings per Share:		
As Reported		\$0.18
Pro Forma		\$0.17

TEP:

	Three Months Ended M 2004	
	-Thousands of Dollars	
Net Income - As Reported	\$	794
Add: Equity-based compensation expense included in reported net income, net of related tax effects		1,119
Deduct: Total equity-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(1,730)
Pro Forma Net Income	\$	183

The fair value of each stock option grant is estimated on the date of

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grant using the Black-Scholes option-pricing model. There were no stock options granted in the first quarter of 2004. For the 21,222 options granted under the Directors' Plan in 2003, the following weighted average assumptions were used:

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Expected life (years)  
Interest rate  
Volatility  
Dividend yield  
Weighted-average grant-date fair value of options granted  
during the period

---

### NOTE 2. PROPOSED ACQUISITION OF UNISOURCE ENERGY

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At a special meeting held on March 29, 2004, UniSource Energy's shareholders voted to approve an acquisition agreement UniSource Energy entered into on November 21, 2003 with Saguaro Acquisition Corp., a wholly-owned indirect subsidiary of Saguaro Utility Group L.P. (Saguaro Utility), providing for the acquisition of all of the common stock of UniSource Energy for \$25.25 per share by an affiliate of Saguaro Utility. The acquisition agreement provides that Saguaro Acquisition Corp. will merge with and into UniSource Energy, with UniSource

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### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

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Energy surviving the merger as a wholly-owned indirect subsidiary of Saguaro Utility. Upon consummation of the acquisition, Saguaro Utility will cause the surviving corporation to pay approximately \$880 million in cash to UniSource Energy's shareholders and holders of stock options, stock units, restricted stock and performance shares awarded under our stock based compensation plans. In connection with the closing of the acquisition, Saguaro Utility intends to cause the surviving corporation (i) to repay the \$95 million inter-company loan to UniSource Energy from TEP and (ii) to contribute up to \$168 million to TEP. TEP will use a significant portion of these proceeds to retire some of its outstanding debt. UniSource Energy expects the acquisition, which is subject to several conditions, including receipt of certain regulatory approvals, to occur in the second half of 2004.

The acquisition agreement contains operating covenants with respect to the operations of UniSource Energy's business pending the consummation of the acquisition. Generally, unless UniSource Energy obtains Saguaro Acquisition Corp.'s prior written consent, UniSource Energy must conduct business in the ordinary course consistent with past practice and use all commercially reasonable efforts to preserve substantially intact the present business organization and present regulatory, business and employee relationships. In addition, the acquisition agreement restricts certain activities, subject to the receipt of Saguaro Acquisition Corp.'s prior written consent, including the issuance or repurchase of capital stock, the amendment of organizational documents, acquisitions and dispositions of assets, capital expenditures, incurrence of indebtedness, modification of employee compensation and benefits, changes in accounting methods, discharge of liabilities, and matters relating to

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UniSource Energy's investment in Millennium.

Either UniSource Energy or Saguaro Acquisition Corp. may terminate the acquisition agreement in certain circumstances, including if the acquisition is not consummated by March 31, 2005 or certain regulatory approvals are not obtained. In certain circumstances, upon the termination of the acquisition agreement, UniSource Energy would be required to pay Saguaro Acquisition Corp.'s expenses related to the acquisition agreement and a termination fee in an aggregate amount of up to \$25 million.

An affiliate of Saguaro Utility entered into a \$410 million credit agreement on March 25, 2004 that will be funded upon closing of the acquisition of UniSource Energy. The credit agreement includes a \$50 million revolving credit facility for general corporate purposes and a \$360 million term loan to be used to fund a portion of the acquisition. The lenders' obligation to make such loans are subject to various customary closing conditions.

The March 29, 2004 shareholder vote to approve the proposed merger triggered vesting of all outstanding stock options under the Omnibus Plan, but no additional compensation expense resulted from such vesting. See Note 13 for a description of additional compensation expense recorded for the performance shares due to accelerated vesting of the awards as a result of the March 29, 2004 shareholder vote.

### NOTE 3. REGULATORY MATTERS

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#### REGULATORY ACCOUNTING

TEP and UES generally use the same accounting policies and practices used by unregulated companies for financial reporting under GAAP. However, sometimes these principles, such as Statement of Financial Accounting Standards No. 71, Accounting for the Effects of Certain Types of Regulation (FAS 71), require special accounting treatment for regulated companies to show the effect of regulation. For example, in setting TEP's and UES' retail rates, the Arizona Corporation Commission (ACC) may not allow TEP or UES to currently charge their customers to recover certain expenses, but instead requires that these expenses be charged to customers in the future. In this situation, FAS 71 requires that TEP and UES defer these items and show them as regulatory assets on the balance sheet until TEP and UES are allowed to charge their customers. TEP and UES then amortize these items as expense to the income statement as these charges are recovered from customers. Similarly, certain revenue items may be deferred as regulatory liabilities, which are also eventually amortized to the income statement as rates to customers are reduced.

The conditions a regulated company must satisfy to apply the accounting policies and practices of FAS 71 include:

- o an independent regulator sets rates;
- o the regulator sets the rates to recover specific costs of delivering service; and

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- o the service territory lacks competitive pressures to reduce rates below the rates set by the regulator.

### IMPLICATIONS OF DISCONTINUING APPLICATION OF FAS 71

#### TEP

Upon approval by the ACC of a settlement agreement (TEP Settlement Agreement) in November 1999, TEP discontinued application of FAS 71 for its generation operations. TEP continues to apply FAS 71 to its regulated operations, which include the transmission and distribution portions of its business.

TEP's regulatory assets, net of regulatory liabilities, totaled \$274 million at March 31, 2004. Regulatory assets of \$22 million are not presently included in rate base and consequently are not earning a return on investment.

TEP regularly assesses whether it can continue to apply FAS 71 to its regulated operations. If TEP stopped applying FAS 71 to these operations, it would write off the related balances of its regulatory assets as an expense and its regulatory liabilities as income on its income statement. Based on the regulatory asset balances, net of regulatory liabilities, at March 31, 2004, if TEP had stopped applying FAS 71 to its remaining regulated operations, it would have recorded an extraordinary after-tax loss of \$165 million. While regulatory orders and market conditions may affect cash flows, TEP's cash flows would not be affected if it stopped applying FAS 71 unless a regulatory order limited its ability to recover the cost of its regulatory assets.

#### UES

UES' regulatory liabilities, net of regulatory assets, totaled \$2 million at March 31, 2004. This amount includes a \$0.2 million asset related to underrecovered purchased gas costs under UNS Gas' Purchased Gas Adjuster (PGA), and a \$0.8 million liability related to overrecovered purchased power costs under UNS Electric's Purchased Power and Fuel Adjuster Clause (PPFAC). If UES stopped applying FAS 71 to its regulated operations, it would write off the related balances of its regulatory assets as an expense and its regulatory liabilities as income on its income statement. Based on the regulatory liability balances, net of regulatory assets, at March 31, 2004, if UES had stopped applying FAS 71 to its regulated operations, it would have recorded an extraordinary after-tax gain of \$1 million. UES' cash flows would not be affected if it stopped applying FAS 71 unless a regulatory order limited its ability to recover the cost of its regulatory assets.

### RECENT REGULATORY ACTION FOR UES

In September 2003, the ACC approved a PGA surcharge of \$0.1155 per therm that took effect October 1, 2003. On March 23, 2004, the ACC approved the termination of the surcharge effective October 31, 2004. At March 31, 2004, the PGA balance was \$0.2 million.

#### NOTE 4. TEP CREDIT FACILITY

-----

On March 25, 2004, TEP entered into a new \$401 million credit agreement. The agreement replaces the credit facilities provided under TEP's \$401 million credit agreement that would have expired in 2006. The new credit agreement includes a \$60 million revolving credit facility for general corporate purposes and a \$341 million letter of credit facility, to support \$329 million

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aggregate principal amount of tax-exempt variable rate bonds. The credit agreement has a five year term through June 30, 2009 and is secured by \$401 million in aggregate principal amount of Second Mortgage Bonds issued under TEP's General Second Mortgage Indenture.

The credit agreement contains a number of restrictive covenants, including restrictions on additional indebtedness, liens, sale of assets and sale-leasebacks. The credit agreement also contains several financial covenants including: (a) minimum consolidated tangible net worth, (b) a minimum cash coverage ratio, and (c) a maximum leverage ratio. Under the terms of the credit agreement, TEP may pay dividends so long as it maintains compliance with the credit agreement. The previous credit agreement had provided that dividends could not exceed 65% of TEP's net income. The elimination of such covenant is expected to satisfy, in part, one of the closing conditions contained in the acquisition agreement that UniSource Energy entered into with Saguaro

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### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

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Acquisition Corp. by permitting TEP to dividend all of its net income to its shareholders. The credit agreement also provides that under certain circumstances, certain regulatory actions could result in a required reduction of the commitments. As of March 31, 2004, TEP was in compliance with the terms of the Credit Agreement.

The letter of credit fee of 2.35% on the new facility is significantly lower than the previous credit agreement's weighted average letter of credit fee of approximately 5%. The agreement also provides for letter of credit fronting fees of 0.25%, which will reduce to 0.125% upon the closing of Saguaro Acquisition Corp.'s acquisition of UniSource Energy; the previous agreement's fronting fee was 0.25%. Unreimbursed drawings on a letter of credit bear a variable rate of interest based on LIBOR plus 2.25% per annum. Interest savings in 2004 will be partially offset by the write-off of fees associated with the prior facility that were capitalized and being amortized through 2006 and the amortization of fees associated with the entry of the new facility. TEP wrote-off \$2 million in fees associated with the prior facility in March 2004, included in Long-Term Debt Interest Expense in UniSource Energy and TEP's income statements.

If TEP borrows under the revolving credit facility, the borrowing costs would be at a variable interest rate consisting of a spread over LIBOR or an alternate base rate. The spread is based upon a pricing grid tied to TEP's leverage. The per annum rate currently in effect on borrowings under TEP's revolving credit facility, based on its leverage, is LIBOR plus 2.25%. If TEP's leverage were to change, the spread over LIBOR could range from 1.50% to 2.25%. Also, TEP pays a commitment fee of 0.50% on the unused portion of the revolving credit facility.

### NOTE 5. ACCOUNTING CHANGE: ACCOUNTING FOR ASSET RETIREMENT OBLIGATIONS

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TEP has identified legal obligations to retire generation plant assets specified in land leases for its jointly-owned Navajo and Four Corners Generating Stations. TEP also has certain environmental obligations at the San



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Juan Generating Station (San Juan). TEP has estimated that its share of these obligations will be approximately \$38 million at the date of retirement. As of March 31, 2004 and December 31, 2003, TEP had accrued approximately \$1 million for the final decommissioning of its generating facilities. This amount has been recorded as an accrued asset retirement obligation on the UniSource Energy and TEP balance sheets.

TEP and UES have various transmission and distribution lines that operate under land leases and rights of way that contain end dates and restorative clauses. TEP and UES operate their transmission and distribution systems as if they will be operated in perpetuity and would continue to be used or sold without land remediation. A final retirement occurs when an entire transmission or distribution line is permanently removed from service. Interim retirements occur as components of the system are replaced. As a result, TEP and UES are not recognizing the costs of final removal of the transmission and distribution lines in their financial statements. As of March 31, 2004 and December 31, 2003, TEP had accrued \$62 million and \$60 million and UES had accrued \$1 million for the net cost of removal for interim retirements from its transmission, distribution and general plant. These amounts have been recorded as a regulatory liability on the UniSource Energy and TEP balance sheets.

Millennium and UED have no asset retirement obligations.

Upon adoption of FAS 143 on January 1, 2003, TEP recorded an asset retirement obligation of \$38 million at its net present value of \$1 million, increased depreciable assets by \$0.1 million for asset retirement costs, reversed \$113 million of costs previously accrued for final removal from accumulated depreciation, reversed previously recorded deferred tax assets of \$44 million and recognized the cumulative effect of accounting change as a gain of \$112 million (\$67 million net of tax). The adoption of FAS 143 also resulted in a \$6 million reduction of current depreciation expense charged throughout the year because asset retirement costs are no longer recorded as a component of depreciation expense.

### NOTE 6. ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND TRADING ACTIVITIES

-----

TEP, UES and MEG's derivative activities are discussed fully in UniSource Energy and TEP's 2003 Annual Report on Form 10-K.

TEP has a natural gas supply agreement under which it purchases all of its gas requirements at spot market prices from Southwest Gas Corporation (SWG). TEP also has agreements to purchase power that are priced using spot market gas prices. These contracts meet the definition of normal purchases and are not required

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

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to be marked to market. In the first quarter of 2004, in an effort to minimize price risk on these purchases, TEP entered into commodity price swap agreements under which TEP purchases gas at fixed prices and simultaneously sells gas at spot market prices. The spot market price in the swap agreements is tied to the same index as the purchases under the SWG and purchased power contracts. These swap agreements, which will expire during the summer months of

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2004 through 2006, were entered into with the goal of locking in fixed prices on at least 45% and not more than 80% of TEP's expected summer monthly gas risk prior to entering into the month. The swap agreements are marked to market on a monthly basis; however, since the agreements satisfy the requirements for cash flow hedge accounting, the unrealized gains and losses are recorded in Other Comprehensive Income, a component of Common Stock Equity, rather than being reflected in the income statement.

TEP and MEG's derivative activities are reported as follows:

- o TEP's net unrealized and realized gains and losses on forward sales contracts are components of Electric Wholesale Sales;
- o TEP's net unrealized and realized gains and losses on forward purchase contracts are components of Purchased Power;
- o TEP's net unrealized gains and losses on commodity price swaps are included in Other Comprehensive Income, which is a component of Common Stock Equity; and
- o MEG's net unrealized and realized gains and losses on trading activities are components of Other Operating Revenues. Although MEG's realized gains and losses on trading activities are reported net on UniSource Energy's income statement, the related cash receipts and cash payments are reported separately on UniSource Energy's statement of cash flows.

The net pre-tax unrealized gains and losses from TEP's forward contracts were less than \$1 million for each of the three month periods ended March 31, 2004 and 2003. The net pre-tax realized and unrealized gains and losses from MEG's trading activities were also less than \$1 million for each of the three month periods ended March 31, 2004 and 2003. The net pre-tax unrealized gains and losses from TEP's commodity swap agreements recorded as cash flow hedges and included in Other Comprehensive Income were just over \$1 million as of March 31, 2004. TEP had no material cash flow hedges as of December 31, 2003.

TEP's derivative assets and liabilities are reported in Other Current Asset and Other Current Liabilities on TEP and UniSource Energy's balance sheets. The fair value of TEP's derivative assets was \$1 million at March 31, 2004 and the fair value of TEP's derivative liabilities was less than \$1 million at December 31, 2003. MEG's trading assets and liabilities are reported in Trading Assets and Trading Liabilities on UniSource Energy's balance sheet. The fair value of MEG's trading assets, including its Emissions Allowance inventory, was \$49 million at March 31, 2004 and \$22 million at December 31, 2003. The fair value of MEG's trading liabilities was \$44 million at March 31, 2004 and \$19 million at December 31, 2003.

Beginning January 1, 2004, the settlement of forward purchase and sales contracts that do not result in physical delivery are recorded net as a component of Electric Wholesale Sales in TEP's income statement. For the three months ended March 31, 2004, \$1 million in sales were netted against \$1 million in purchases, resulting in a small net gain.

### NOTE 7. BUSINESS SEGMENTS (Restated - See Note 18)

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

- (1) TEP, a vertically integrated electric utility business, is UniSource

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- Energy's largest subsidiary.
- (2) UES is the holding company for UNS Gas, a regulated gas distribution business, and UNS Electric, a regulated electric distribution utility business. See Note 1.
- (3) Millennium holds interests in unregulated energy and emerging technology businesses. See Note 8.
- (4) UED develops generating resources and other project development activities, including facilitating the expansion of the Springerville Generating Station.

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### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

Significant reconciling adjustments consist of the elimination of intercompany activity and balances. Millennium recorded revenue from transactions with TEP of \$3 million and \$2 million during the three-month periods ended March 31, 2004 and March 31, 2003, respectively. TEP's related expense is reported in Other Operations and Maintenance expense on its income statement. Millennium's revenue and TEP's related expense are eliminated in UniSource Energy consolidation. Other significant reconciling adjustments include the elimination of the intercompany note between UniSource Energy and TEP, as well as the related interest income and expense.

We record our percentage share of the earnings of affiliated companies, except for investments where we provide all of the financing, in which case we recognize 100% of the losses. See Note 8.

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

	Segments			
	TEP	UES	Millennium	
				- Millions of Dollars
Income Statement				
.....				
Three months ended March 31, 2004:				
.....				
Operating Revenues - External	\$ 187	\$ 81	\$ 2	\$
.....				
Operating Revenues - Intersegment	-	-	3	
.....				
Income Before Income Taxes	3	8	3	
.....				
Net Income	1	5	2	
.....				
.....				
Three months ended March 31, 2003:				
.....				
Operating Revenues - External	\$ 172	\$ -	\$ 1	\$
.....				
Operating Revenues - Intersegment	-	-	2	

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Loss Before Income Taxes and Cumulative Effect of Accounting Change	(12)	-	(8)
Net Income (Loss)	59	-	(5)

Balance Sheet

Total Assets, March 31, 2004	\$ 2,696	\$ 312	\$ 202	\$
Total Assets, December 31, 2003	2,767	309	181	

NOTE 8. MILLENNIUM

See Note 7 for selected financial data of Millennium.

Through affiliates, Millennium holds investments in unregulated energy and emerging technology companies. As presented in Note 7, Millennium's assets represent 5% of UniSource Energy's total assets at March 31, 2004 and 4% at December 31, 2003. Under the acquisition agreement described in Note 2, UniSource Energy is limited as to the amount it can invest in Millennium in the future. Consequently, Millennium's ability to provide future funding for the operations of emerging companies could be affected.

Millennium accounts for these investments under the consolidation and equity methods. In some cases, Millennium is an investment's sole funder. When this is the case, Millennium recognizes 100% of an investment's losses, because as sole provider of funds it bears all of the financial risk. To the extent an investment becomes profitable and Millennium has recognized losses in excess of its percentage ownership, Millennium will recognize 100% of an investment's net income until Millennium's recognized losses equal its ownership percentage of losses.

A brief summary of Millennium's investments follows:

GLOBAL SOLAR ENERGY, INC. (Global Solar) primarily develops and manufactures light weight thin-film photovoltaic cells and panels. Global Solar's target markets have included military, space and commercial applications. Millennium owns 99% of Global Solar. Millennium accounts for Global Solar under the consolidation

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

method and recognizes 100% of Global Solar's losses. Global Solar recognizes

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expense when funding is used for research, development and administrative costs. During the first quarter of 2004, Millennium made no contributions to Global Solar. However, UniSource Energy provided \$2 million to Global Solar under a tax sharing agreement.

Millennium has no remaining funding commitments to Global Solar, other than the tax sharing agreement with UniSource Energy.

INFINITE POWER SOLUTIONS, INC. (IPS) develops thin-film lithium ion batteries. Millennium owns 72% of IPS and accounts for it under the consolidation method. IPS recognizes expense when funding is used for research, development and administrative costs. During the first quarter of 2004, Millennium funded its remaining debt commitment of \$0.5 million to IPS. Dow Corning Enterprises, Inc. (DCEI) made no additional contributions to IPS during the same time period. In April 2004, Millennium and DCEI committed to loan up to an additional \$1 million each to IPS, and each funded \$0.5 million of the commitment at that time. Millennium's remaining debt commitment to IPS is currently \$0.5 million and is contingent on IPS' attainment of certain performance criteria. Pursuant to the terms of the amended promissory notes with IPS, Millennium and DCEI have the right to convert at any time the outstanding debt amounts to equity ownership. DCEI holds warrants to purchase additional preferred shares of IPS that if exercised, could result in Millennium's ownership of IPS being reduced to as low as 59%.

MICROSAT SYSTEMS, INC. (MicroSat) develops small-scale satellites under a U.S. government contract. In February 2004, pursuant to a settlement agreement, the contract was terminated and MicroSat granted the government purpose rights to the design data and transferred all hardware assets developed under the contract to the government in exchange for the elimination of further cost-sharing obligations under the contract. These assets will be used under a new contract between MicroSat and the government, and may be used by the government for other satellite development contracts not involving MicroSat. However, MicroSat retains the right to use the design data on other government and commercial contracts. MicroSat had previously deferred \$2 million, before tax, of revenues earned under the original contract. These revenues have now been recognized, and Millennium recorded the income in the first quarter of 2004. Millennium owns 35% of MicroSat and, as sole funder, recognizes 100% of MicroSat's net losses. Millennium made no contributions to MicroSat during the first quarter of 2004 and has no further funding commitments to MicroSat.

MEG is a wholly-owned subsidiary of Millennium, which manages and trades emissions allowances, coal, and related financial instruments. MEG's activities are described in Note 6.

HADDINGTON ENERGY PARTNERS II, LP (Haddington) funds energy-related investments. A member of the UniSource Energy Board of Directors has an investment in Haddington and is a managing director of the general partner of the limited partnership. Millennium committed \$15 million in capital, excluding fees, to Haddington in exchange for approximately 31% ownership. At March 31, 2004, Millennium had funded \$9 million of this commitment, none of which was funded during the first quarter of 2004. Millennium expects the balance to be funded over the next three years. In March 2004, Haddington sold one of its investments and recognized the related gain as income. Millennium recorded its share of Haddington's income in the first quarter of 2004. In April 2004, Millennium received a \$7 million distribution from Haddington related to the sale. Millennium accounts for its investment in Haddington under the equity method.

VALLEY VENTURES III, LP (Valley Ventures) is a venture capital fund that invests in information technology, microelectronics and biotechnology, primarily within the southwestern U.S. Another member of the UniSource Energy Board of Directors is a general partner of the company that manages the fund. Millennium committed \$6 million, including fees, to the fund and owns

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approximately 15% of the fund. As of March 31, 2004, Millennium had funded \$2 million of this commitment, \$0.6 million of which was funded during the first quarter of 2004. Millennium expects the balance to be funded by the end of 2007. Millennium accounts for this investment under the equity method due to an ability to exercise significant influence over the fund based on the related party affiliation disclosed above.

CARBOELECTRICA SABINAS, S. DE R.L. DE C.V. (Sabinas) is a Mexican limited liability company created to develop up to 800 megawatts (MW) of coal-fired generation in the Sabinas region of Coahuila, Mexico. Sabinas also owns 19.5% of Minerales de Monclova, S.A. de C.V. (Mimosa). Mimosa is an owner of coal and associated gas reserves. Mimosa supplies metallurgical coal to the Mexican steel industry and thermal coal to the major electric utility in Mexico. Millennium owns 50% of Sabinas. Altos Hornos de Mexico, S.A. de C.V. (AHMSA) and affiliates own the remaining 50%. UniSource Energy's Chairman, President and Chief Executive Officer is an alternate member of the board of directors of AHMSA. Since 1999, both AHMSA and Mimosa are parties to a suspension of payments procedure, under applicable Mexican law, which is the equivalent of a U.S. Chapter 11

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### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

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proceeding. Under certain circumstances, Millennium has the right to sell (a put option) its interest in Sabinas to an AHMSA affiliate for \$20 million plus an accrued service fee. These circumstances include failure of Sabinas to reach financial closing on the generation project within a specified time. Millennium's put option is secured by collateral initially valued in excess of \$20 million. Millennium accounts for the investment in Sabinas under the equity method; however, Sabinas accounts for its investment in Mimosa under the cost method.

NATIONS ENERGY CORPORATION (Nations Energy) is wholly owned by Millennium. Through subsidiaries, Nations Energy has a 32% interest in a 43 MW power plant in Panama. Nations Energy intends to sell its interest in this plant, the book value of which is currently less than \$1 million.

#### NATIONS ENERGY CONTINGENCY

In September 2001, Nations Energy sold its 26% equity interest in a power project located in Curacao, Netherlands Antilles to Mirant Curacao Investments, Ltd. (Mirant Curacao), a subsidiary of Mirant Corporation (Mirant). Nations Energy received \$5 million in cash and an \$11 million note receivable from Mirant Curacao. The note was recorded at its net present value of \$8 million using an 8% discount rate, the discount being recognized as interest income over the five-year life of the note. As of March 31, 2004, Nations Energy's receivable from Mirant Curacao is approximately \$10 million. The note is primarily included in Investments and Other Property - Other on UniSource Energy's balance sheet. Payments on the note receivable are expected as follows: \$2 million in July 2004, \$4 million in July 2005, and \$5 million in July 2006.

The note is guaranteed by Mirant Americas, Inc., a subsidiary of Mirant. On July 14, 2003, Mirant, Mirant Americas, Inc. and various other Mirant companies filed for Chapter 11 bankruptcy protection. Mirant Curacao was not included in the Chapter 11 filings. Based on a review of the projected cash flows for the power project, it appears Mirant Curacao will have sufficient

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future cash flows to pay the note receivable and any applicable interest. However, we cannot predict the ultimate outcome that Mirant's bankruptcy will have on the collectibility of the note from Mirant Curacao. Nations Energy will continue to evaluate the collectibility of the receivable, but currently expects to collect the note in its entirety and has not recorded any reserve for this note.

### MILLENNIUM COMMITMENTS

Millennium's funding levels and share ownership are subject to change in the future. Millennium's outstanding equity commitments are currently limited to \$6 million to Haddington and \$4 million to Valley Ventures. Millennium's only remaining debt commitment is \$0.5 million to IPS. Millennium may commit to provide additional funding to its investments in the future.

Global Solar had commitments totaling \$1 million at March 31, 2004 and December 31, 2003 to incur future expenses relating to government contracts.

### NOTE 9. COMMITMENTS AND CONTINGENCIES

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#### MILLENNIUM COMMITMENTS AND CONTINGENCY

See Note 8 for a description of Millennium's commitments and contingency.

#### UNISOURCE ENERGY CONTINGENCIES

##### Acquisition Fees

UniSource Energy has entered into agreements with New Harbor Incorporated (New Harbor) and Morgan Stanley & Co. Incorporated (Morgan Stanley) in connection with the acquisition of UniSource Energy by Saguaro Utility. The transaction fee payable to New Harbor is \$9 million. UniSource Energy paid New Harbor \$2 million upon announcement of the transaction in November 2003, with the balance of the transaction fee contingent and payable upon the closing of the transaction. UniSource Energy has agreed to pay Morgan Stanley a transaction fee of up to \$3 million, which includes their monthly advisory fee, in connection with the acquisition. UniSource Energy paid Morgan Stanley \$1 million in November 2003 and \$0.4 million in April 2004 upon shareholders approving the transaction, and will pay Morgan Stanley \$1 million contingent and payable upon the acquisition closing.

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### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

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In certain circumstances, in the event of termination of the acquisition agreement, UniSource Energy would be required to pay Saguaro Acquisition Corp.'s expenses and a termination fee in an aggregate amount of up to \$25 million.

#### Withdrawal of Litigation Concerning the Proposed Acquisition Agreement

On March 17, 2004, plaintiffs withdrew two shareholder derivative lawsuits, McBride v. Pignatelli, et al. and Zetooney v. Pignatelli, et al.,

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filed in the Superior Court of the State of Arizona on November 24, 2003, the same day that UniSource Energy announced details of its proposed acquisition by Saguaro Utility Group, L.P. UniSource Energy paid no consideration in connection with the withdrawal of the lawsuits. In these two lawsuits, which were virtually identical, the plaintiffs alleged that UniSource Energy's Board of Directors, in its consideration and approval of the acquisition agreement, breached its fiduciary duty to UniSource Energy's shareholders in approving the acquisition agreement.

### TEP CONTINGENCIES

#### Springerville Generating Station Complaint

Environmental activist groups have expressed concerns regarding the construction of any new units at the Springerville Generating Station. In January 2003, environmental activist groups appealed an ACC Order affirming the ACC's approval of the expansion at the Springerville Generating Station to the Superior Court of the State of Arizona. On October 22, 2003, the Superior Court affirmed the ACC's issuance of the Certificate of Environmental Compatibility for Springerville Generating Station. The Court granted TEP and the ACC's motion for summary judgment from the environmental activist groups. The environmental activist groups appealed the Superior Court decision on December 30, 2003 and filed an amended notice of appeal on January 2, 2004.

In November 2001, the Grand Canyon Trust (GCT), an environmental activist group, filed a complaint in U.S. District Court against TEP for alleged violations of the Clean Air Act at the Springerville Generating Station. The complaint alleged that more stringent emission standards should apply to Units 1 and 2. These standards would require new permits and the installation of additional facilities, meeting Best Available Control Technology standards, for the continued operation of Units 1 and 2. In 2002, the U.S. District Court granted TEP's motion for summary judgment on one of the primary issues in the case: whether TEP commenced construction within 18 months and/or by March 19, 1979, after the original 1977 air permit covering Units 1 and 2 was issued. The Court found that TEP had commenced construction of the Springerville Generating Station in the time periods required by the original permits. There were two remaining allegations: that (a) TEP discontinued construction for a period of 18 months or longer and did not complete construction in a reasonable period of time, and (b) TEP did not commence construction, for purposes of New Source Performance Standard applicability, by September 18, 1978. On March 4, 2003, the U.S. District Court determined that the GCT had not commenced the case on a timely basis and dismissed the case. The GCT has appealed this decision to the U.S. Court of Appeals for the 9th Circuit. Oral argument on the matter was heard by the 9th Circuit on April 15, 2004, and a decision is pending.

TEP believes these claims are without merit and intends to vigorously contest them.

#### Litigation and Claims Related to San Juan Generating Station

On May 16, 2002, the GCT and the Sierra Club filed a citizen lawsuit under the Clean Air Act in federal district court in New Mexico against Public Service Company of New Mexico (PNM) as operator of San Juan. TEP owns 50% of San Juan Units 1 and 2, which equates to 19.8% of the total San Juan Station. The lawsuit alleges two violations of the Clean Air Act and related regulations and permits. One of the two claims, concerning the initial permitting of San Juan, was dismissed by the court in August 2003. The remaining claim alleged that PNM violated its present Title V operating permit for Units 1, 3 and 4 by exceeding the 20% opacity standard on numerous occasions between 1998 and 2002; opacity is a means to monitor the particulate matter contained in an emission. PNM was directed to make a written settlement offer on the remaining claim by May 28, 2004, with the plaintiffs directed to respond by June 11, 2004. A settlement



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conference has been scheduled before the federal magistrate on July 1, 2004. The trial will continue in the third quarter of 2004 if the parties are unable to reach settlement.

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### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

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In September 2003, the New Mexico Environment Department (NMED) notified PNM, operator of San Juan, of alleged excess emissions and opacity in violation of the permits at San Juan Units 1, 3, and 4. The NMED issued a draft compliance order assessing unspecified civil penalties. PNM has entered into discussions with the NMED concerning the alleged excess emissions and opacity violations. No compliance order has been issued in this matter.

Based on the information available to date, TEP does not believe resolution of these matters will be material to TEP.

#### Postretirement and Pension Benefit Costs at Various Generating Stations

The coal suppliers to Springerville Generating Station and each of TEP's remote generating stations have submitted demands for payment by TEP of postretirement and pension benefit costs for these coal suppliers' employees under the coal supply agreements with TEP. Peabody Western Coal Company (Peabody), the coal supplier to the Navajo Generating Station, has filed a lawsuit against the participants at Navajo, including TEP, for retiree postretirement benefit costs. TEP owns 7.5% of the Navajo Generating Station. In December 2003, the Navajo participants and Peabody agreed to stay the discovery process in this litigation until August 31, 2004 to give the parties time to explore a possible settlement. To the extent that amounts become known and payment probable, TEP will record a liability for additional postretirement and pension benefit costs at the Springerville, Navajo, and San Juan Generating Stations. TEP does not expect any settlement to be material to TEP.

The claim for postretirement at Four Corners was settled as part of the coal contract extension. TEP paid \$0.3 million for postretirement benefits in settlement in September 2003.

#### Environmental Reclamation at Remote Generating Stations

TEP pays on-going reclamation costs at each of its remote generating stations, and it is probable that TEP will have to pay a portion of final reclamation costs at the coal mines which supply the remote generating stations. In June 2003, TEP received an estimate of the reclamation liability at the coal mine that supplies San Juan in which post-term reclamation activities are assumed to occur over a 16-year period beginning in 2028. The expected aggregate undiscounted reclamation liability totals \$122 million of which TEP's portion of the liability, based on its ownership of San Juan, totals \$24 million. The present value of TEP's liability for post-term reclamation at a 10% credit-adjusted risk free rate approximates \$7 million at December 31, 2017, the expiration date of the coal supply agreement, and will be recognized over the remaining term of the coal supply agreement. At March 31, 2004, TEP has recorded \$0.4 million of its post-term reclamation liability at San Juan. Amounts recorded for post-term reclamation are subject to various assumptions and determinations, such as estimating the costs of reclamation, estimating when final reclamation will occur, and the credit-adjusted risk-free interest rate to be used to discount future liabilities. Changes that may arise over time with

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regard to these assumptions and determinations will change amounts recorded in the future as expense for post-term reclamation. TEP does not believe that recognition of its post-term reclamation obligation at San Juan will be material to TEP in any single year since recognition occurs over the remaining 14 year life of its coal supply agreement.

Although a cost is probable at TEP's other remote generating stations, it is not possible at this time to reasonably estimate the amount of any obligation for final reclamation because remediation alternatives have not yet advanced to the stage where a reasonable estimate of any cost can be made. As amounts become known, TEP will recognize a liability for final reclamation over the remaining lives of its coal supply agreements.

### GUARANTEES AND INDEMNITIES

In the normal course of business, UniSource Energy and certain subsidiaries, including TEP, enter into various agreements providing financial or performance assurance to third parties on behalf of certain subsidiaries. We enter into these agreements primarily to support or enhance the creditworthiness of a subsidiary on a stand-alone basis. The most significant of these guarantees are 1) UES' guarantee of \$160 million of aggregate principal amount of senior unsecured notes issued by UNS Gas and UNS Electric to purchase the Citizens Arizona gas and electric system assets, 2) UniSource Energy's guarantee of approximately \$22 million in natural gas transportation and supply payments in addition to building lease payments for UNS Gas, UNS Electric, and subsidiaries of Millennium, and 3) Millennium's guarantee of approximately \$3 million in commodity-related payments for MEG at March 31, 2004. To the extent liabilities exist under the contracts subject to these guarantees, such liabilities are included in UniSource Energy's consolidated balance sheets.

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### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

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In addition, UniSource Energy and its subsidiaries have indemnified the purchasers of interests in certain investments from additional taxes due for years prior to the sale. The terms of the indemnifications provide for no limitation on potential future payments; however, we believe that we have abided by all tax laws and paid all tax obligations. We have not made any payments under the terms of these indemnifications to date.

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

### NOTE 10. TEP WHOLESALE ACCOUNTS RECEIVABLE AND ALLOWANCES

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At March 31, 2004 and December 31, 2003, TEP's Allowance for Doubtful Accounts on the balance sheet includes \$10 million related to 2001 and 2000 sales to the California Power Exchange (CPX) and the California Independent System Operator (CISO).

TEP's collection shortfall from the CPX and the CISO was approximately \$9 million for sales made in 2000 and \$7 million for sales made in 2001. Since that time, the FERC has held hearings and the FERC staff has proposed various methodologies for calculating amounts of refunds/offsets applicable to wholesale

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sales made into the CISO's spot markets from October 2000 to June 2001. As of December 31, 2002, TEP had reserved \$8 million, or 50%, of its outstanding receivable based on the amount TEP believed would be collected. Based upon a FERC order in March 2003 (as reaffirmed by the FERC on October 16, 2003), TEP estimated that it may receive approximately \$6 million of its \$16 million receivable. This represents amounts owed to TEP net of TEP's estimated refund liability. Therefore, in the first quarter of 2003, TEP increased its reserve for sales to the CPX and the CISO by \$2 million by recording a reduction of wholesale revenues.

There are several other outstanding legal issues, complaints and lawsuits concerning the California energy crisis related to the FERC, wholesale power suppliers, Southern California Edison Company, Pacific Gas and Electric Company, the CPX and the CISO. We cannot predict the outcome of these issues or lawsuits. We believe, however, that TEP is adequately reserved for its transactions with the CPX and the CISO.

TEP's Accounts Receivable from Electric Wholesale Sales are included in Trade Accounts Receivable on the balance sheet. TEP's wholesale receivables, net of allowances, totaled \$23 million as of March 31, 2004 and \$26 million at December 31, 2003. Excluding the receivables from the CPX and the CISO, as described above, substantially all of the March 31, 2004 wholesale receivable balance has been collected as of the date of this filing.

NOTE 11. UNISOURCE ENERGY EARNINGS PER SHARE (EPS)

Basic EPS is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted EPS assumes that proceeds from the hypothetical exercise of stock options and other equity-based awards are used to repurchase outstanding shares of stock at the average fair market price during the reporting period. The numerator in calculating both basic and diluted earnings per share for each period is net income. The following table shows the effects of potential dilutive common stock on the weighted average number of shares:

	Thr
	20
-----	
	- In
Denominator:	
Weighted-average Shares of Common Stock Outstanding	34,1
Effect of Dilutive Securities:	
Options and Stock Issuable under Employee Benefit Plans and the Directors' Plan	7
-----	
Total Shares	34,8
=====	

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There were no antidilutive options as of March 31, 2004. The dilutive share base for the quarter ended March 31, 2003 excludes 1,406,000 options and contingently issuable shares due to their antidilutive effect as a result of UniSource Energy's loss before cumulative effect of accounting change.

### NOTE 12. EMPLOYEE BENEFITS PLANS

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#### PENSION BENEFIT PLANS

TEP and UES maintain noncontributory, defined benefit pension plans for substantially all regular employees and certain affiliate employees. Benefits are based on years of service and the employee's average compensation. TEP and UES fund the plans by contributing at least the minimum amount required under Internal Revenue Service regulations. Additionally, we provide supplemental retirement benefits to certain employees whose benefits are limited by IRS benefit or compensation limitations.

#### OTHER POSTRETIREMENT BENEFIT PLANS

TEP provides limited health care and life insurance benefits for retirees. All regular employees may become eligible for these benefits if they reach retirement age while working for TEP or an affiliate. Concurrent with the acquisition of the Arizona gas and electric assets from Citizens on August 11, 2003, UES assumed a \$2 million liability for postretirement medical benefits for current retirees and a small group of active employees. The majority of UES employees do not participate in the postretirement medical plan.

The ACC allows TEP and UES to recover postretirement costs through rates only as benefit payments are made to or on behalf of retirees. The postretirement benefits are currently funded entirely on a pay-as-you-go basis. Under current accounting guidance, TEP and UES cannot record a regulatory asset for the excess of expense calculated per Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, over actual benefit payments.

#### COMPONENTS OF NET PERIODIC BENEFIT COST

The components of net periodic benefit costs are as follows:

	Pension Benefits		Other Postretirement Benefits	
	Three Months Ended March 31, 2004	2003	Three Months Ended March 31, 2004	2003
-----				
-Millions of Dollars -				
Components of Net Periodic Benefit Cost				
Service Cost	\$ 1.5	\$ 1.2	\$ 0.5	\$ 0.5
Interest Cost	2.4	2.1	0.9	0.9
Expected Return on Plan Assets	(2.7)	(2.3)	-	-
Prior Service Cost Amortization	0.5	0.4	(0.4)	(0.4)
Recognized Actuarial (Gain) Loss	0.4	0.5	0.5	0.5
-----				
Net Periodic Benefit Cost	\$ 2.1	\$ 1.9	\$ 1.5	\$ 1.5
=====				

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EMPLOYER CONTRIBUTIONS

We previously disclosed in our financial statements for the year ended December 31, 2003 that TEP's and UES' expected pension plan contributions in 2004 were \$6 million and \$0.5 million, respectively. As of March 31, 2004, TEP anticipates making contributions of \$5 million in 2004 of which \$1 million have been made. UES presently anticipates contributing \$1 million in 2004.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

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NOTE 13. EQUITY-BASED COMPENSATION PLANS

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We account for UniSource Energy's two equity-based compensation plans, the Directors' Plan and the Omnibus Plan, under the recognition and measurement principles of APB 25 and related interpretations. See Note 1.

The acquisition agreement discussed in Note 2 limits the amount of capital stock that UniSource Energy can issue under its stock plans, and requires that both of UniSource Energy's stock plans must be terminated effective as of the closing of the merger. Additionally, both plans contain "Change in Control" provisions that provide for accelerated vesting of awards when certain conditions are met. The March 29, 2004 shareholder vote to approve the proposed merger triggered 100% vesting of all awards under the Omnibus Plan. The provision in the Directors Plan results in 100% vesting of all awards if and when the merger is consummated.

At March 31, 2004, we had stock options, stock units and restricted stock grants outstanding as discussed below.

STOCK OPTIONS

No stock options have been granted under the Directors' Plan in 2004. A total of 21,222 stock options were granted under this plan during the three-month period ended March 31, 2003. There were no stock options granted to key employees under the Omnibus Plan during the three-month periods ended March 31, 2004 or 2003. Director stock option awards currently vest over three years, become exercisable in one-third increments on each anniversary date of the grant and expire on the tenth anniversary of the grant.

A summary of the stock option activity of the Directors' Plan and Omnibus Plan is as follows:

	Three Months Ended March 31,		
	2004	2003	
	Shares	Weighted Average Exercise Price	Shares
			Weighted Average Exercise Price

Options Outstanding,

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Beginning of Period	2,478,551	\$16.04	2,576,819	\$15.
Granted	-	-	21,222	\$17.
Exercised	(203,791)	\$14.90	(2,257)	\$12.
Forfeited	(1,134)	\$13.85	(2,866)	\$13.
	-----		-----	
Options Outstanding, End of Period	2,273,626	\$16.15	2,592,918	\$15.
	=====		=====	
Options Exercisable, End of Period	2,249,624	\$16.13	1,644,400	\$14.
Weighted Average Remaining Contractual Life at March 31, 2004:			6.22	

As discussed in Note 1, we apply APB 25 in accounting for our stock option plans. We have not recognized any compensation cost for these options because our stock options are granted with an exercise price equal to the market value of the stock at the grant date. We have also adopted the disclosure-only provisions of FAS 123. We present, in Note 1, the effect on net income and earnings per share as if the company had applied the fair value recognition provisions of FAS 123, as required by FAS 148.

Stock options awarded on January 1, 2002 accrue dividend equivalents that are paid in cash on the earlier of the date of exercise of the underlying option or the date the option expires. Compensation expense is recognized as dividends are declared. In the first quarter of 2004 and 2003, we recognized compensation expense of less than \$0.1 million for dividend equivalents on stock option grants.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

RESTRICTED STOCK AND STOCK UNITS

In the first quarter of 2004 and 2003, we granted restricted stock awards to directors totaling 6,480 shares and 5,157 shares, respectively. The grant date fair value of the shares was \$24.68 per share in 2004 and \$17.44 per share in 2003. Directors may elect to receive stock units in lieu of restricted shares. As discussed above, Directors' awards were not affected by the shareholder vote to approve the proposed merger. The restricted shares or stock units become 100% vested on the third anniversary of the grant date, or on consummation of the merger. Compensation expense equal to the fair market value on the date of the award is recognized over the vesting period. We recorded compensation expense of less than \$0.1 million in the first quarter of 2004 and 2003 related to these awards.

There were no new stock unit awards granted under the Omnibus Plan in the first quarter of 2004 or 2003. When awards are granted, compensation expense equal to the fair market value on the date of the award is recognized over a three or four year vesting period. All stock unit awards under the Omnibus Plan had fully vested as of March 6, 2004 and were not impacted by the shareholder vote to approve the proposed merger. We recognized compensation expense related to earlier awards of less than \$0.1 million in each quarter.

PERFORMANCE SHARES

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In May 2003, the Board of Directors approved a grant of performance shares to key employees under the Omnibus Plan. The shares were to be awarded at the end of a three-year performance period based on goal attainment. The grant date fair value was \$17.84 per share. Compensation expense was initially recorded over the performance period based on the anticipated number and market value of shares to be awarded. As a result of the shareholder vote to approve the proposed merger, 53,566 performance shares vested and were distributed. Compensation expense of \$2 million was recorded in the first quarter of 2004 for this award.

NOTE 14. INCOME AND OTHER TAXES (Restated - See Note 18)

### INCOME TAXES

The differences between the income tax expense (benefit) and the amount obtained by multiplying pre-tax income (loss) before cumulative effect of accounting change by the U.S. statutory federal income tax rate of 35% are as follows:

	UniSource Energy	
	Three Months Ended	
	March 31,	
	2004	2003
	-Thousand	
Federal Income Tax Expense (Benefit) at Statutory Rate	\$ 4,316	\$ (8,32)
State Income Tax Expense (Benefit), Net of Federal Deduction	566	(1,09)
Depreciation Differences (Flow Through Basis)	789	1,08
Tax Credits	(129)	(38)
Other	367	4
Income Tax Expense (Benefit)	5,909	(8,67)
Tax on Cumulative Effect of Accounting Change (See Note 5)	-	44,23
Total Federal and State Income Tax Expense	\$ 5,909	\$ 35,56

The total Federal and State Income Tax Expense (Benefit) in the table above is included on UniSource Energy and TEP's income statements.

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

#### OTHER TAXES

TEP and UES act as conduits or collection agents for excise tax (sales tax) as well as franchise fees and regulatory assessments. They record liabilities payable to governmental agencies when electricity is delivered to customers. Neither the amounts billed nor payable are reflected in the income

statement.

NOTE 15. NEW ACCOUNTING PRONOUNCEMENTS

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The FASB recently issued the following Statements of Financial Accounting Standards (FAS) and FASB Interpretations (FIN):

- o FIN 46, Consolidation of Variable Interest Entities, was issued in January 2003, and was subsequently revised in December 2003 (FIN 46R). The primary objectives of FIN 46R are to provide guidance on the identification of entities for which control is achieved through means other than through voting rights (variable interest entities) and to determine when and which business enterprises should consolidate the variable interest entity (primary beneficiary). FIN 46R requires that both the primary beneficiary and all other enterprises with a significant variable interest make additional disclosures. For public companies, the revised FIN 46R is effective for financial periods ending after March 15, 2004. The adoption of FIN 46R did not and is not expected to have a significant impact on our financial statements.
  
- o FAS 132, Employers' Disclosures about Pensions and Other Postretirement Benefits (revised 2003), was issued by the FASB in December 2003. FAS 132 requires additional disclosures about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans beyond those in the original Statement 132 which it replaces. FAS 132, as revised, is effective for fiscal years ending after December 15, 2003. The revised disclosure requirements are included in Note 12 above.

In August 2003, the Emerging Issues Task Force (EITF) published Issue No. 03-11, Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, and Not "Held for Trading Purposes" as Defined in EITF Issue No. 02-3 (EITF 03-11). EITF 03-11 discusses whether realized gains and losses should be shown gross or net in the income statement for contracts that are not held for trading purposes, as defined in EITF 02-3, but are derivatives subject to FAS 133. Determining whether realized gains and losses on derivative contracts not held for trading purposes should be reported in the income statement on a gross or net basis is a matter of judgment that depends on the relevant facts and circumstances with respect to the various activities of the entity. Retroactive application of EITF 03-11 is not required. Beginning January 1, 2004, the realized gains and losses on derivative instruments that are not held for trading purposes but are eventually net settled are shown net in the income statement. The impact of adopting EITF 03-11 was immaterial as of March 31, 2004. See Note 6.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

-----  
NOTE 16. SUPPLEMENTAL CASH FLOW INFORMATION (Restated - See Note 18)

-----  
A reconciliation of net income to net cash flows from operating activities follows:



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	-----	UniS
		Three
		2004
	-----	-Thousa
Net Income		\$ 6,421
Adjustments to Reconcile Net Income		
To Net Cash Flows		
Cumulative Effect of Accounting Change-Net of Tax		
Depreciation and Amortization Expense		35,13
Depreciation Recorded to Fuel and Other O&M Expense		1,55
Amortization of Transition Recovery Asset		8,59
Net Unrealized Gain on TEP Forward Electric Sales		(50)
Net Unrealized Loss on TEP Forward Electric Purchases		32
Net Unrealized Gain on MEG Trading Activities		(1,58)
Amortization of Deferred Debt-Related Costs included in Interest Expense		2,39
Provision for Bad Debts		94
Deferred Income Taxes		21,06
(Gains) Losses from Equity Method Entities		(6,89)
Other		2,59
Changes in Assets and Liabilities which Provided (Used)		
Cash Exclusive of Changes Shown Separately		
Accounts Receivable		15,34
Materials and Fuel Inventory		(62)
Accounts Payable		(11,98)
Interest Accrued		(30,82)
Income Tax Receivable		(3,56)
Taxes Accrued		(3,31)
Other Current Assets		(17,35)
Other Current Liabilities		24,71
Net Cash Flows - Operating Activities		\$ 42,44
	=====	

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

	-----	Three
		2004
	-----	-Thousa
Net Income		\$ 79

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### Adjustments to Reconcile Net Income

#### To Net Cash Flows

Cumulative Effect of Accounting Change-Net of Tax	30,41
Depreciation and Amortization Expense	1,55
Depreciation Recorded to Fuel and Other O&M Expense	8,59
Amortization of Transition Recovery Asset	(50)
Net Unrealized Gain on TEP Forward Electric Sales	32
Net Unrealized Loss on TEP Forward Electric Purchases	2,31
Amortization of Deferred Debt-Related Costs included in Interest Expense	56
Provision for Bad Debts	21,97
Deferred Income Taxes	(3)
Gains from Equity Method Entities	(2,32)
Interest on Note Receivable from UniSource Energy	(21)
Other	
Changes in Assets and Liabilities which Provided (Used)	
Cash Exclusive of Changes Shown Separately	
Accounts Receivable	10,14
Materials and Fuel Inventory	25
Accounts Payable	(6,61)
Interest Accrued	(27,94)
Income Tax Receivable	(8,81)
Taxes Accrued	(1,62)
Other Current Assets	5,50
Other Current Liabilities	(24)

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Net Cash Flows - Operating Activities	\$34,12
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#### NOTE 17. REVIEW BY INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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With respect to the unaudited condensed consolidated financial information of UniSource Energy and TEP for the three-month period ended March 31, 2004 and 2003, PricewaterhouseCoopers LLP reported that they have applied limited procedures in accordance with professional standards for a review of such information. However, their separate report dated May 3, 2004 except as to the restatement of unbilled revenue described in Note 18, as to which the date is August 19, 2004 appearing herein states that they did not audit and they do not express an opinion on that unaudited condensed consolidated financial information. Accordingly, the degree of reliance on their report on such information should be restricted in light of the limited nature of the review procedures applied. PricewaterhouseCoopers LLP is not subject to the liability provisions of Section 11 of the Securities Act of 1933 (the Act) for their report on the unaudited condensed consolidated financial information because that report is not a "report" or a "part" of a registration statement prepared or certified by PricewaterhouseCoopers LLP within the meaning of Sections 7 and 11 of the Act.

#### NOTE 18. CHANGE IN UNBILLED REVENUE ESTIMATION METHODOLOGY AT TEP

---

TEP's and UES' retail revenues include an estimate of MWhs/therms delivered but unbilled at the end of each period. Unbilled revenues are dependent upon a number of factors that require management's judgment including estimates of retail sales and customer usage patterns. The unbilled revenue is estimated by comparing the estimated MWhs/therms delivered to the MWhs/therms billed to TEP and UES retail customers. The excess of MWhs/therms delivered over MWhs/therms billed is then allocated to the retail customer classes

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

based on estimated usage by each customer class. TEP and UES then record revenue for each customer class based on the various bill rates for each customer class. Due to the seasonal fluctuations of TEP's actual load, the unbilled revenue amount increases during the spring and summer months and decreases during the fall and winter months. The unbilled revenue amount for UES gas sales increases during the fall and winter months and decreases during the spring and summer months, whereas, the unbilled revenue amount for UES electric sales increases during the spring and summer months and decreases during the fall and winter months.

During the second quarter of 2004, we determined that the kWh information used to estimate kWhs delivered to TEP's customers was generally understated. Additionally, we determined that TEP's existing method of pricing computed unbilled kWh sales quantities among customer classes was weighting usage by lower-priced customers too heavily and weighting usage by higher-priced customers too lightly. For TEP, the price paid by customers varies from a low of 3.7 cents per kWh for interruptible industrial load to a high of 13 cents per kWh for small commercial customers, so that allocations among customer classes are a significant element of unbilled revenues. Effective with the second quarter of 2004, we changed the estimation methodology used to quantify unbilled kWh sales and price the computed unbilled kWh sales quantities to more accurately reflect actual usage and restated prior periods including the three months ended March 31, 2004 and 2003.

Under the revised estimation methodology, unbilled sales are estimated for the month by reviewing the meter reading schedule and determining the number of billed and unbilled kWhs for each cycle. Current month unbilled kWhs are allocated by customer class. New unbilled revenue amounts are recorded and unbilled revenue estimates from the prior month are reversed. The primary difference between the prior estimation methodology and the current methodology results from the reversal of the prior month's accrued unbilled revenue rather than a methodology that had the effect of reversing unbilled kWhs, and a more precise application of the current rates by customer class to kWhs unbilled at the end of each month.

The Condensed Consolidated Statements of Income for the three months ended March 31, 2004 and 2003 and the Condensed Consolidated Balance Sheets and Statement of Capitalization as of March 31, 2004 of UniSource Energy and TEP have been restated to correct the reported revenues. The change in methodology and correction of reported revenues resulted in the following revisions to the consolidated financial statements:

Consolidated Statements of Income

	UniSource Energy	
	As Previously Reported	As Restated
Three Months Ended March 31, 2004		

-Thousands

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Electric Retail Sales	\$ 174,387	\$174,36
Operating Revenues	270,108	270,08
Amortization of Transition Recovery Asset	8,468	8,59
Total Operating Expenses	227,245	227,37
Operating Income	42,863	42,71
Income Before Income Taxes and Cumulative Effect of Accounting Change	12,483	12,33
Income Taxes	5,970	5,90
Income Before Cumulative Effect of Accounting Change	6,513	6,42
Net Income	6,513	6,42
Basic EPS:		
-----		
Income (Loss) Before Cumulative Effect of Accounting Change	\$0.19	\$0.1
Net Income	\$0.19	\$0.1
Diluted EPS:		
-----		
Income (Loss) Before Cumulative Effect of Accounting Change	\$0.19	\$0.1
Net Income	\$0.19	\$0.1

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONTINUED)

Consolidated Statements of Income

Three Months Ended March 31, 2003	UniSource Energy	
	As Previously Reported	As Restated
	-----	
	-Thousands	
Electric Retail Sales	\$130,545	\$129,13
Operating Revenues	173,657	172,24
Amortization of Transition Recovery Asset	3,608	3,72
Total Operating Expenses	160,059	160,17
Operating Income	13,598	12,06
Income Before Income Taxes and Cumulative Effect of Accounting Change	(22,268)	(23,79)
Income Taxes	(8,067)	(8,67)
Income Before Cumulative Effect of Accounting Change	(14,201)	(15,12)
Net Income	53,270	52,34
Basic EPS:		
-----		
Income (Loss) Before Cumulative Effect of Accounting Change	\$ (0.42)	\$ (0.4

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Net Income	\$ 1.58	\$ 1.5
Diluted EPS:		
-----		
Income (Loss) Before Cumulative Effect of Accounting Change	\$ (0.42)	\$ (0.4
Net Income	\$ 1.58	\$ 1.5

Consolidated Balance Sheets

	UniSource Energy	
	-----	
	As	
March 31, 2004	Previously Reported	As Restate
	-----	
	-Thousands	
Trade Accounts Receivable	\$ 85,570	\$ 94,03
Unbilled Accounts Receivable	17,900	41,33
Total Current Assets	318,965	341,10
Transition Recovery Asset	267,468	265,58
Total Regulatory and Other Assets	381,725	379,84
Total Assets	3,055,629	3,079,44
Common Stock Equity	546,755	563,48
Deferred Income Taxes - Noncurrent	101,168	106,03
Total Capitalization	2,551,720	2,568,44
Taxes Accrued	45,679	47,90
Total Current Liabilities	259,732	261,95
Total Capitalization and Other Liabilities	3,055,629	3,079,44

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - AS RESTATED (CONCLUDED)

Consolidated Statements of Capitalization

	UniSource Energy	
	-----	
	As	
March 31, 2004	Previously Reported	As Restate
	-----	
	-Thousands	
Accumulated Deficit	\$ (125,449)	\$ (108,72
Total Common Stock Equity	546,755	563,48

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

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Certain information in Management's Discussion and Analysis of Financial Condition and Results of Operations for UniSource Energy and TEP has been restated. For further information, see Note 18 in Notes to Condensed Consolidated Financial Statements.

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

- o outlook and strategy,
- o operating results during the first quarter of 2004 compared with the same period in 2003,
- o factors which affect our results and outlook,
- o liquidity, capital needs, capital resources, and contractual obligations,
- o dividends, and
- o critical accounting policies.

Management's Discussion and Analysis should be read in conjunction with UniSource Energy and TEP's 2003 Form 10-K and with the Condensed Consolidated Financial Statements, beginning on page 2, which present the results of operations for the three months ended March 31, 2004 and 2003. Management's Discussion and Analysis explains the differences between periods for specific line items of the Condensed Consolidated Financial Statements.

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

OVERVIEW OF CONSOLIDATED BUSINESS

UniSource Energy Corporation (UniSource Energy) is a holding company that owns substantially all of the outstanding common stock of Tucson Electric Power Company (TEP), and all of the outstanding common stock of UniSource Energy Services, Inc. (UES), Millennium Energy Holdings, Inc. (Millennium), and UniSource Energy Development Company (UED).

TEP, an electric utility, has provided electric service to the community of Tucson, Arizona, for over 100 years. UES, through its two operating subsidiaries, provides gas and electric service to 30 communities in northern and southern Arizona. Millennium invests in unregulated businesses, including a developer of thin-film batteries and a developer and manufacturer of thin-film photovoltaic cells. UED engages in developing generating resources and other project development activities, including facilitating the expansion of the Springerville Generating Station. We conduct our business in these four primary business segments -- TEP's Electric Utility Segment, UES' Gas and Electric Utility Segment, the Millennium Businesses Segment, and the UED Segment.

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TEP is the principal operating subsidiary of UniSource Energy and, at March 31, 2004, represented approximately 85% of its assets. The seasonal nature of TEP's business causes operating results to vary significantly from quarter to quarter. UniSource Energy's results for the three months ended March 31, 2004 include a full quarter of operations of UES. Due to sales of both winter-peaking gas and summer-peaking electricity, UES' consolidated operating results are expected to be less seasonal than TEP's. Although representing approximately 5% of UniSource Energy's total assets, results from Millennium's unregulated businesses had a significant impact on earnings reported by UniSource Energy for the three months ended March 31, 2004 and 2003. UED's unregulated business segment, which was established in February 2001, had a significant impact on consolidated net income and cash flows in the fourth quarter of 2003 since the financial closing of Springerville Unit 3 occurred on October 21, 2003. UED did not have a significant impact on net income or cash flow in the first quarter of 2003 or 2004, nor is it expected to in future periods.

### OUTLOOK AND STRATEGIES

#### AGREEMENT AND PLAN OF MERGER

On November 21, 2003, UniSource Energy and Saguaro Acquisition Corp., a Delaware corporation, entered into an acquisition agreement providing for the acquisition of all of the common stock of UniSource Energy for \$25.25 per share by an affiliate of Saguaro Utility Group L.P., an Arizona limited partnership (Saguaro Utility), whose general partner is Sage Mountain, L.L.C. and whose limited partners include investment funds affiliated with Kohlberg Kravis Roberts & Co.,

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L.P., J.P. Morgan Partners, LLC and Wachovia Capital Partners. Frederick B. Rentschler is the managing member of Sage Mountain L.L.C., an Arizona limited liability company.

Pursuant to the terms of the acquisition agreement, Saguaro Acquisition Corp., a wholly-owned and indirect subsidiary of Saguaro Utility, will merge with and into UniSource Energy. UniSource Energy will be the surviving corporation, but will become an indirect wholly-owned subsidiary of Saguaro Utility. Trading in our stock on the New York Stock Exchange and the Pacific Exchange will cease immediately as of the effective time of the acquisition. After that time, the surviving corporation will delist our shares from the New York Stock Exchange and the Pacific Exchange and de-register our shares under the Securities Exchange Act of 1934, as amended. UniSource Energy's and TEP's headquarters will remain in Tucson, and we expect that UniSource Energy's and TEP's senior management team will remain generally the same.

Upon the closing of the acquisition, Saguaro Utility will cause the surviving corporation to pay approximately \$880 million in cash to UniSource Energy's shareholders and holders of stock options, stock units, restricted stock and performance shares awarded under our stock based compensation plans. In connection with the closing of the acquisition, Saguaro Utility intends to cause the surviving corporation (i) to repay the \$95 million inter-company loan to UniSource Energy from TEP and (ii) to contribute up to \$168 million to TEP. TEP will use a significant portion of these proceeds to retire some of its outstanding debt.

On March 25, 2004, an affiliate of Saguaro Utility entered into a \$410 million credit agreement in connection with a commitment obtained by Saguaro Utility from lenders in November 2003. The credit agreement will be funded upon

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closing of the acquisition of UniSource Energy. It includes a \$50 million revolving credit facility for general corporate purposes and a \$360 million term loan to be used to fund a portion of the acquisition. The lenders' obligations to make such loans are subject to various closing conditions customary for credit facilities to be used in an acquisition of this type.

UniSource Energy's shareholders approved the acquisition agreement at a special meeting on March 29, 2004. The acquisition still requires approval by the Arizona Corporation Commission (ACC), the Securities and Exchange Commission (SEC) under the Public Utility Holding Company Act and the Federal Regulatory Commission (FERC) under the Federal Power Act, and the satisfaction of other conditions set forth in the acquisition agreement. UniSource Energy filed an application with the ACC for approval of the acquisition on December 29, 2003. The waiting period under the Hart-Scott-Rodino Antitrust Improvement Act was terminated on March 19, 2004. Saguaro Utility filed an application with the SEC for approval of the acquisition on March 30, 2004. On April 7, 2004, UniSource Energy and Saguaro Utility filed a joint application with FERC under the Federal Power Act for approval of the acquisition.

On April 30, 2004, the staff of the ACC and other intervenors in the ACC proceeding filed testimony relating to the proposed acquisition. In its testimony, the staff of the ACC concluded that the lack of substantial commitments by UniSource Energy and Saguaro Utility in a number of areas and the financial risks created by a lack of financial protection of our utilities call for disapproval of the acquisition as proposed. However, the staff testimony suggested a number of conditions that, if agreed to, would, in their view, significantly mitigate the risks associated with the acquisition. These conditions address: financial protection of the utility businesses; service quality and reliability; affiliate transactions; corporate governance; regulatory oversight; and community presence. The Residential Utility Consumer Office also filed testimony opposing the acquisition, expressing similar concerns to those contained in the staff's testimony. UniSource Energy's rebuttal testimony is due May 25, 2004 and a public hearing of the application before an administrative law judge is scheduled for June 21, 2004.

Subject to the receipt of the required regulatory approvals and the satisfaction of the other closing conditions contained in the acquisition agreement, we expect to close the transaction in the second half of 2004.

### OPERATING PLANS AND STRATEGIES

Our financial prospects and outlook for the next few years will be affected by many competitive, regulatory and economic factors. Our plans and strategies include the following:

- o Obtain all necessary regulatory approvals and satisfy all of the other closing conditions contained in the acquisition agreement so that the acquisition of UniSource Energy by an affiliate of Saguaro Utility can occur in a timely manner.

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- o Integrate UES' businesses with UniSource Energy's other businesses to achieve the strategic and financial objectives of the acquisition.
- o Oversee the construction of Springerville Unit 3 and continue to enhance the value of existing assets by working with Salt River Project



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to facilitate the development of Springerville Unit 4.

- o Enhance the value of TEP's transmission system while continuing to provide reliable access to generation for TEP's retail customers and market access for all generating assets. This will include focusing on completing the Tucson - Nogales transmission line, which could eventually be connected to Mexico's utility system and improve reliability for customers of UNS Electric.
- o Continue to manage our existing Millennium investments to maximize their value.
- o Improve production and sales of Global Solar's thin-film photovoltaic cells and seek strategic partners.
- o Reduce TEP's debt, using some of our excess cash flows.
- o Efficiently manage TEP's generating resources and look for ways to reduce or control our operating expenses while maintaining and enhancing reliability and profitability.

To accomplish our goals, during 2004 we expect TEP to spend approximately \$106 million on capital expenditures and UES to spend approximately \$37 million on capital expenditures.

While we believe that our plans and strategies will continue to have a positive impact on our financial prospects and position, we recognize that we continue to be highly leveraged, and as a result, our access to the capital markets may be limited or more expensive than for less leveraged companies.

### UNISOURCE ENERGY CONSOLIDATED

#### RESULTS OF OPERATIONS

Three Months Ended March 31, 2004 Compared with the Three Months Ended March 31, 2003

UniSource Energy recorded net income of \$6 million, or \$0.19 per average share of Common Stock, in the first quarter of 2004 compared with net income of \$52 million, or \$1.55 per average share of Common Stock last year. Results in the first quarter of 2003 include an after-tax gain of \$67 million, or \$2.00 per average share of Common Stock, for the Cumulative Effect of Accounting Change from the adoption of Statement of Financial Accounting Standards No. 143, Accounting for Asset Retirement Obligations (FAS 143). The net loss before the Cumulative Effect of Accounting Change was \$15 million, or \$0.45 per average share of Common Stock. The following factors contributed to the change in net income:

- o A \$54 million increase in utility gross margin (the sum of electric retail revenues, electric wholesale revenues and gas revenues, less fuel expense and purchased energy expense) resulting from:
  - \$49 million of gas revenues and \$31 million of electric revenues at UES;
  - a \$14 million increase in retail revenues at TEP resulting from a 2% increase in the retail customer base, colder-than-usual weather during the months of January and February, and warmer-than-usual temperatures during the month of March;
  - a \$9 million decline in purchased power expense at TEP,

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resulting from fewer planned and unplanned outages at TEP's generating facilities during the first quarter of 2004, reducing the need to purchase replacement power to meet retail demand; partially offset by:

- \$53 million of purchased energy expense at UES.
- o A \$14 million increase in other operations and maintenance expense (O&M) due to \$14 million of O&M at UES.
- o A \$3 million increase in total interest expense due to \$3 million of long-term debt interest expense at UES.

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- o Income of \$3 million (net of tax) related to Haddington Energy Partners II, LP, (Haddington) one of Millennium's equity method investments.
- o Expenses of \$2 million related to the proposed acquisition of UniSource Energy.

### CONTRIBUTION BY BUSINESS SEGMENT

The table below shows the contributions to our consolidated after-tax earnings by our four business segments, as well as parent company expenses.

Restated - See Note 18 in the Financial Statements	Three Months Ended March 31,	
	2004	2003
Business Segment	- Millions of Dollars -	
TEP (1)	\$ 1	\$ 59
UES	5	-
Millennium	2	(5)
UED	-	-
UniSource Energy Standalone (2)	(2)	(2)
Consolidated Net Income	\$ 6	\$ 52

### LIQUIDITY AND CAPITAL RESOURCES

#### UNISOURCE ENERGY CONSOLIDATED CASH FLOWS

Three Months Ended March 31,	2004	2003
	- Millions of Dollars -	
Cash Provided by (Used in):		
Operating Activities	\$ 42	\$ 10

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Investing Activities	(28)	(34)
Financing Activities	(54)	(43)
Net Decrease in Cash	\$ (40)	\$ (67)

UniSource Energy's consolidated cash flows are provided primarily from retail and wholesale energy sales at TEP and UES, net of the related payments for fuel and purchased power. Typically, cash from operations is lowest in the first quarter and highest in the third quarter due to TEP's summer peaking load.

We use our available cash primarily to:

- o finance capital expenditures at TEP and UES;
- o make investments in our technology affiliates;
- o pay dividends to shareholders; and
- o reduce leverage at TEP by repaying high coupon debt and investing in lease debt.

The primary source of liquidity for UniSource Energy, the parent company, is dividends it receives from its subsidiaries, primarily TEP, from their cash flow from operations. See Tucson Electric Power Company, Liquidity and Capital Resources, Dividends, below.

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Accrued interest on UniSource Energy's promissory note to TEP of approximately \$20 million is payable every two years; the last payment of \$20 million was made to TEP in December 2003. Under our tax allocation procedures our subsidiaries make income tax payments to UniSource Energy, which makes payments on behalf of the consolidated group.

As of May 4, 2004, cash and cash equivalents available to UniSource Energy was approximately \$90 million.

As part of our ACC Holding Company Order, we must invest at least 30% of any proceeds of UniSource Energy equity issuances in TEP until TEP's equity reaches 37.5% of total capital (excluding capital leases).

### Operating Activities

In the first quarter of 2004, net cash flows from operating activities increased by \$32 million compared with the same period in 2003. The following factors contributed to the increase:

- o a \$57 million increase in cash receipts from retail and wholesale energy customers, net of fuel and purchased energy costs, due to energy sales at UES and increased retail electric sales at TEP; partially offset by:
- o an \$11 million increase in income taxes and other taxes paid due to taxes paid at UES and a larger final tax payment related to prior year consolidated income tax returns;
- o a \$10 million increase in O&M due to \$6 million of O&M at UES and acquisition-related costs;

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- o a \$5 million increase in wages paid due primarily to \$4 million of wages paid at UES and incentive compensation payments to management pursuant to their employment arrangements triggered by the shareholder approval of the proposed acquisition of UniSource Energy; and
- o \$5 million of cash interest paid at UES.

### Investing Activities

Net cash used for investing activities was \$6 million lower in the first quarter of 2004 compared with the same period in 2003, due primarily to a \$14 million decline in capital expenditures at TEP partially offset by \$8 million of capital expenditures at UES. The lower capital expenditures at TEP are primarily the result of the timing of expected projects.

### Financing Activities

Net cash used for financing activities was \$12 million higher in the first quarter of 2004 compared with the same period in 2003. The following factors contributed to the increase:

- o TEP paid \$9 million in debt issue costs related to the refinancing of its Credit Agreement; and
- o a \$6 million increase in scheduled payments for TEP's capital lease obligations; partially offset by:
- o an increase in other cash inflows of \$4 million related to cash received from stock option exercises and new TEP and UES customer deposits.

Our consolidated cash and cash equivalents decreased to \$61 million at March 31, 2004, from \$101 million at December 31, 2003. We invest cash balances in high-grade money market securities with an emphasis on preserving the principal amounts invested.

In the event that we experience lower cash from operations in 2004, we may adjust our discretionary uses of cash accordingly. We believe, however, that we will continue to have sufficient cash flow to cover our capital needs, as well as required debt payments and dividends to shareholders.

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### GUARANTEES AND INDEMNITIES

In the normal course of business, UniSource Energy and certain subsidiaries, including TEP, enter into various agreements providing financial or performance assurance to third parties on behalf of certain subsidiaries. We entered into these agreements primarily to support or enhance the creditworthiness of a subsidiary on a stand-alone basis. The most significant of these guarantees are UES' guarantee of \$160 million of aggregate principal amount of senior unsecured notes issued by UNS Gas and UNS Electric to purchase the Citizens' Arizona gas and electric system assets, UniSource Energy's guarantee of approximately \$22 million in natural gas and supply payments and building lease payments for UNS Gas and UES, and Millennium's guarantee of approximately \$3 million in commodity-related payments for MEG at March 31, 2004. To the extent liabilities exist under the contracts subject to these guarantees, such liabilities are included in the consolidated balance sheets.

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In addition, UniSource Energy and its subsidiaries have indemnified the purchasers of interests in certain investments from additional taxes due for years prior to the sale. The terms of the indemnifications provide for no limitation on potential future payments; however, we believe that we have abided by all tax laws and paid all tax obligations. We have not made any payments under the terms of these indemnifications to date.

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

### CONTRACTUAL OBLIGATIONS

There have been no significant changes in our contractual obligations or other commercial commitments from those reported in our 2003 Annual Report on Form 10-K.

### DIVIDENDS ON COMMON STOCK

The following table shows the declared dividends to UniSource Energy shareholders for 2004.

Declaration Date	Record Date	Payable Date	Dividend Per Share
February 6, 2004	February 17, 2004	March 10, 2004	
May 7, 2004	May 18, 2004	June 10, 2004	

The acquisition agreement allows UniSource Energy to continue to pay regular quarterly cash dividends until the closing of the acquisition, subject to limitations upon our ability to increase the amount of such dividends. UniSource Energy's Board of Directors currently expects to continue to pay regular quarterly cash dividends on UniSource Energy's Common Stock until the closing of the acquisition, subject, however, to its evaluation of our financial condition, earnings, cash flows and dividend policy.

### INCOME TAX POSITION

At March 31, 2004, UniSource Energy and TEP had, for federal and state income tax filing purposes, the following carryforward amounts (Restated - See Note 18 in the Financial Statements):

	UniSource Energy Amount -Millions of Dollars-	Expiring Year	Amount -Millions of Dollars-
Net Operating Losses	\$ 55	2006-2023	\$32
Investment Tax Credit	8	2004-2023	8
AMT Credit	88	-	85

Of the \$55 million in NOL carryforwards at UniSource Energy, \$18 million is subject to limitation due to a reorganization of certain Millennium entities in December 2002. The future use of these losses is dependant upon the generation of sufficient future taxable income at the separate company level. See Critical Accounting Policies, Deferred Tax Valuation - TEP and Millennium, below.

## TUCSON ELECTRIC POWER COMPANY

## RESULTS OF OPERATIONS

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

## TEP kWh Sales and Revenues

Customer growth, weather and other consumption factors affect retail sales of electricity. Electric wholesale revenues are affected by market prices in the wholesale energy market, availability of TEP generating resources, the price of fuel, and the level of wholesale forward contract activity.

TEP kWh sales delivered and corresponding revenues for the quarter ended March 31, 2004 compared with the quarter ended March 31, 2003 are detailed below.

Restated - See Note 18 in the Financial Statements

Three Months Ended March 31,	Sales			2004
	2004	2003	Percent Change	
	- Millions of kWh -			-
<b>Electric Retail Sales:</b>				
Residential	719	642	12%	\$ 58
Commercial	358	326	10%	37
Industrial	490	467	5%	36
Mining	192	152	26%	9
Public Authorities	50	51	(2%)	3
<b>Total Electric Retail Sales</b>	<b>1,809</b>	<b>1,638</b>	<b>10%</b>	<b>143</b>
<b>Electric Wholesale Sales Delivered:</b>				
Long-term Contracts	346	329	5%	15
Other Sales	543	610	(11%)	25
Transmission	-	-		2
<b>Total Electric Wholesale Sales</b>	<b>889</b>	<b>939</b>	<b>(5%)</b>	<b>42</b>
<b>Total</b>	<b>2,698</b>	<b>2,577</b>	<b>5%</b>	<b>\$185</b>

TEP's retail customer base increased by 2% to 369,644, while kWh sales to retail customers increased by 10% in the first quarter of 2004 compared with the same period last year. Kilowatt-hour sales to residential customers were up 12% and kWh sales to commercial customers were up 10%, resulting from customer growth, cold weather during January and February, and unseasonably warm weather in March compared with the same period last year. Heating degree days were up 28% in the first quarter of 2004 compared to last year. In March 2004, the high

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temperature exceeded 80 degrees during 20 days, compared with nine days last year. Copper prices were 63% higher in the first three months of 2004 compared with the same period in 2003, leading to increased mining activity and a 26% increase in kWh sales to TEP's mining customers. Revenues from TEP's mining customers increased \$3 million in the first quarter of 2004, benefiting from increased demand and higher prices for copper. The price of energy provided to TEP's mining customers is indexed with the market price of copper. Total revenue from sales to retail customers increased by 11% in 2003, reflecting higher kWh demand.

Wholesale kWh sales were down 5% compared with the first quarter of 2003. The availability of TEP's excess coal-fired generation was limited by higher retail energy demand compared with the first quarter of 2003. In addition, the increase in the regional supply of gas-generated energy allowed TEP to decrease the use of less efficient gas generating units. Despite lower wholesale kWh sales, wholesale revenues increased by \$2 million, or 5%, due to \$1 million of net unrealized gains on forward sales contracts and a \$2 million reserve recorded in the first quarter of 2003 for doubtful accounts related to wholesale sales made to the California Independent System Operator (CISO) and the California Power Exchange (CPX) in 2001 and 2000. See Critical Accounting Policies, TEP - Payment Defaults and Allowances for Doubtful Accounts, below.

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### Fuel and Purchased Power Expenses

Fuel expense at TEP's generating plants increased by \$1 million, or 2%, in the first quarter of 2004, compared with the same period in 2003, due to the higher availability and use of TEP's coal-fired generating facilities. Many of TEP's coal-fired generating facilities underwent major planned outages, as well as unplanned outages, in the first quarter of 2003, limiting their availability. Generation from TEP's low-cost coal facilities was up 441,000 MWh, or 19%, in the first quarter of 2004, while generation from TEP's more costly gas-fired facilities was down 92,000 MWh, or 88%, in the same period. The average cost of fuel per kWh generated for the first quarter of 2004 was 1.71 cents, compared with 1.92 cents for the first quarter of 2003. See Item 3. - Quantitative and Qualitative Disclosures About Market Risk, below.

TEP's Purchased Power expense decreased \$9 million, or 60%, in the first quarter of 2004, compared with the same period in 2003. The higher availability of TEP's coal-fired generating facilities reduced the need to purchase replacement power compared to a year ago. TEP purchased 56% less energy, or 209,000 MWh, in the first three months of 2004 compared with the same period last year.

### Other Operating Expenses

Other Operations and Maintenance expense increased by \$3 million, or 6%, in the first quarter of 2004, compared with the same period in 2003, due to higher incentive compensation and acquisition-related costs allocated to TEP.

Amortization of the Transition Recovery Asset (TRA) increased \$5 million in the first quarter of 2004 compared with the same period in 2003. Amortization of the TRA is the result of the 1999 Settlement Agreement (TEP Settlement Agreement) with the ACC, which changed the accounting method for TEP's generation operations. This item reflects the recovery, through 2008, of transition recovery assets which were previously regulatory assets of the generation business. The amount of amortization is a function of the TRA balance and total kWh consumption by TEP's distribution customers. TEP expects TRA

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amortization to be \$49 million in 2004, \$57 million in 2005, \$66 million in 2006, \$76 million in 2007 and \$26 million in 2008.

### Other Income (Deductions)

TEP's income statement includes inter-company interest income of \$2 million for the first quarter of 2004 compared with \$3 million for the same period in 2003. This represents Interest Income on the promissory note TEP received from UniSource Energy in exchange for the transfer to UniSource Energy of its stock in Millennium in 1998. On UniSource Energy's income statement, this Interest Income, as well as UniSource Energy's related interest expense, is eliminated as an inter-company transaction.

### Interest Expense

Total interest expense did not change in the first quarter of 2004 compared with the same period in 2003. Unamortized fees of \$2 million that were expensed as a result of the refinancing of TEP's Credit Agreement in March 2004 were partially offset by a \$1 million decrease in capital lease interest expense. Interest on capital leases was lower in the first quarter of 2004 due to scheduled repayments of capital lease obligations. See Liquidity and Capital Resources, TEP Cash Flows, Investing Activities, TEP Credit Agreement, below.

### Income Tax Expense

Income tax expense, before Cumulative Effect of Accounting Change, increased \$6 million in the first quarter of 2004 compared with the same period in 2003, due to higher pre-tax income.

### Cumulative Effect of Accounting Change

TEP adopted FAS 143 on January 1, 2003 and recorded a one-time \$67 million after-tax gain. Upon adoption of FAS 143, TEP recorded an asset retirement obligation of \$38 million at its net present value of \$1 million; increased depreciable assets by \$0.1 million for asset retirement costs, reversed \$113 million of costs previously accrued for final removal from accumulated depreciation, and reversed previously recorded deferred tax assets of \$44 million. The adoption of FAS 143 resulted in a reduction to depreciation expense charged throughout the year because asset retirement costs are no longer recorded as a component of depreciation expense. For the years 2004 and 2003, this amount is approximately \$6 million each year. See Critical Accounting Policies - Accounting for Asset Retirement Obligations, below.

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## FACTORS AFFECTING RESULTS OF OPERATIONS

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### COMPETITION

The electric utility industry has undergone significant regulatory change in the last few years designed to encourage competition in the sale of electricity and related services. However, the experience in California with deregulation during 2000 and 2001 has caused many states, including Arizona, to re-examine the viability of retail electric deregulation.

As of January 1, 2001, all of TEP's retail customers became eligible to choose an alternate energy supplier. Although there is one Energy Service Provider (ESP) certified to provide service in TEP's retail service area,



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currently none of TEP's retail customers are receiving service from this ESP. TEP has met all conditions required by the ACC to facilitate electric retail competition, including ACC approval of TEP's direct access tariffs. ESPs must meet certain conditions before electricity can be sold competitively in TEP's service territory. Examples of these conditions include ACC certification of ESPs, and execution of and compliance with direct access service agreements with TEP.

TEP competes against gas service suppliers and others that provide energy services. Other forms of energy technologies may provide competition to TEP's services in the future, but to date, are not financially viable alternatives for its retail customers. Self-generation by TEP's large industrial customers could also provide competition for TEP's services in the future, but has not had a significant impact to date.

In the wholesale market, TEP competes with other utilities, power marketers and independent power producers in the sale of electric capacity and energy.

### RATES

TEP is required to file by June 1, 2004 a general rate case, including an updated cost of service study. Under the terms of the TEP Settlement Agreement, no rate case filed by TEP through 2008, including the June 2004 general filing, may result in a net rate increase. The ACC order approving the Citizens acquisition also requires that TEP submit as part of its June 2004 general rate case filing, a feasibility study and consolidation plan, or in the alternative, a plan for coordination of operations of UNS Electric's operations in Santa Cruz County with those of TEP.

### WESTERN ENERGY MARKETS

As a participant in the western U.S. wholesale power markets, TEP is directly and indirectly affected by changes in market conditions and market participants. TEP competes with other utilities, power marketers and independent power producers in the sale of electric capacity and energy at market-based rates in the wholesale market.

The generating capacity in Arizona is expected to be 24,000 MW by the end of 2004, which represents an increase of 53% as compared with the capacity available at the end of 2000. A majority of this growth is the result of 15 new or upgraded gas-fired generating units with a combined capacity of approximately 8,200 MW. In addition, the presence of fewer creditworthy counterparties, as well as legal, political and regulatory uncertainties, has reduced market liquidity and trading volume.

### Market Prices

The average market price for around-the-clock energy based on the Dow Jones Palo Verde Index decreased in the first quarter of 2004 compared with 2003, as did the average prices for natural gas based on the Permian Index. Beginning in January 2004, all natural gas used by TEP plants originated from the Permian Gas Basin. In previous years, most of TEP's gas supply was priced according to the San Juan Basin Index.

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Quarter ended March 31, 2004	\$40
Quarter ended March 31, 2003	45
Average Market Price for Natural Gas	
-----	
Quarter ended March 31, 2004	\$5.02
Quarter ended March 31, 2003	5.76

Natural gas prices remained high throughout 2003 and into 2004 with continued demand, storage and production concerns. These high gas and subsequent power prices are currently expected to continue at least for the near-term period. Starting in May 2004, the average forward around-the-clock market price at Palo Verde for the balance of the year 2004 is estimated at approximately \$49 per MWh, based on forward market broker quotes as of April 22, 2004. As a result, we expect TEP's fuel and purchased power expense to be higher in 2004 than in 2003, depending on the actual volumes purchased. We cannot predict whether these higher prices will continue, or whether changes in various factors that influence demand and supply will cause prices to fall again during the remainder of 2004.

We expect the market price and demand for capacity and energy to continue to be influenced by the following factors during the next few years:

- o weather;
- o continued population growth in the western U.S.;
- o economic conditions in the western U.S.;
- o availability of generating capacity throughout the western U.S.;
- o the extent of electric utility industry restructuring in Arizona, California and other western states;
- o the effect of FERC regulation of wholesale energy markets;
- o the availability and price of natural gas;
- o availability of hydropower;
- o transmission constraints; and
- o environmental restrictions and the cost of compliance.

### Payment Defaults and Allowances for Doubtful Accounts

See Critical Accounting Policies, TEP - Payment Defaults and Allowances for Doubtful Accounts, below.

### GENERATING RESOURCES

#### Water Supply

Drought conditions in the Four Corners region, combined with water usage in upper New Mexico, have resulted in decreasing water levels in the lake that indirectly supplies water to the San Juan and Four Corners generating stations. These drought conditions may affect the water supply of the plants in 2005, as well as in later years, if adequate moisture is not received in the watershed that supplies the area. TEP has a 50% ownership interest in each of San Juan Units 1 and 2 (322 MW capacity) and a 7% ownership interest in each of Four Corners Units 4 and 5 (110 MW capacity).

The Operating Agents for the plants have negotiated supplemental water contracts with the U.S. Bureau of Reclamation and the Jicarilla Apache Nation for 2004 to assist the plants in meeting their water requirements in the event a water shortage. Additionally, negotiations are underway for supplemental

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of contracts for later years. TEP does not believe that its operations will be materially affected by this drought. However, TEP cannot predict the ultimate outcome of the drought, or whether it will adversely affect the amount of power available from the San Juan and Four Corners generating stations.

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### LIQUIDITY AND CAPITAL RESOURCES

#### TEP CASH FLOWS

Three months ended March 31,	2004	2003
	-Millions of Dollars-	
Cash from Operations	\$ 34	\$ 22
Capital Expenditures	(23)	(37)
Debt Maturities	(1)	(1)
Retirement of Capital Lease Obligations	(44)	(37)
Net Cash Flows Available after Required Payments	\$ (34)	\$ (53)

Cash from operations typically is the lowest in the first quarter and highest in the third quarter due to TEP's summer peaking load. TEP's capital requirements consist primarily of capital expenditures and optional and mandatory redemptions of long-term debt and capital lease obligations.

During 2004, TEP expects to generate sufficient internal cash flows to fund its operating activities, construction expenditures, required debt maturities, and to pay dividends to UniSource Energy. However, TEP's cash flows may vary due to changes in energy prices, natural gas prices, availability of coal-fired generation, changes in short-term interest rates, and other factors. TEP currently has \$60 million available under its Revolving Credit Facility which it may borrow if cash flows fall short of expectations or if monthly cash requirements temporarily exceed available cash balances.

#### Operating Activities

In the first quarter of 2004, net cash flows from operating activities increased by \$13 million compared with the same period in 2003. The following factors contributed to the increase:

- o an \$18 million increase in cash receipts from retail and wholesale electric customers, net of fuel and purchased energy costs, due primarily to higher retail energy demand and lower purchased power costs; and
- o a \$2 million decrease in capital lease interest paid due to lower capital lease obligations outstanding; partially offset by:
  - a \$4 million increase in O&M costs due to costs related to the acquisition of UniSource Energy;
  - a \$2 million increase in income taxes and other taxes paid due primarily to a TEP payment of income taxes to UniSource Energy pursuant to inter-company tax allocation procedures; and

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- a \$1 million increase in wages paid due to higher incentive compensation.

### Investing Activities

Net cash used for investing activities was \$10 million lower in the first quarter of 2004 compared with the same period in 2003, due primarily to a \$14 million decline in capital expenditures, partially offset by \$4 million invested in Springerville Lease Debt. Lower capital expenditures at TEP are primarily the result of the timing of expected projects. We expect TEP's capital expenditures to be approximately \$106 million in 2004.

TEP is currently seeking approvals for the construction of a 62-mile, 345-kV transmission line from Tucson to Nogales, Arizona. The construction costs are expected to be approximately \$75 million. Through March 31, 2004, approximately \$9 million in engineering and environmental expenses have been capitalized related to this project. If the transmission line does not proceed, these costs will be immediately expensed.

### Financing Activities

Net cash used for financing activities was \$12 million higher in the first quarter of 2004 compared with the same period in 2003. The following factors contributed to the increase:

- o \$9 million paid in debt issue costs related to the refinancing of its Credit Agreement; and

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- o a \$6 million increase in scheduled payments for capital lease obligations; partially offset by:
- o an increase in other cash inflows of \$3 million related to interest received on the inter-company note to UniSource Energy and new customer deposits.

### TEP Credit Agreement

On March 25, 2004, TEP entered into a new \$401 million credit agreement. The agreement replaces the credit facilities provided under TEP's \$401 million credit agreement that would have expired in 2006. The new credit agreement includes a \$60 million revolving credit facility for general corporate purposes and a \$341 million letter of credit facility, to support \$329 million aggregate principal amount of tax-exempt variable rate bonds. The credit agreement has a five-year term, expiring June 30, 2009, and is secured by \$401 million in aggregate principal amount of Second Mortgage Bonds issued under TEP's General Second Mortgage Indenture.

The credit agreement contains a number of restrictive covenants, including restrictions on additional indebtedness, liens, sale of assets and sale-leasebacks. The credit agreement also contains several financial covenants including: (a) minimum consolidated tangible net worth, (b) a minimum cash coverage ratio, and (c) a maximum leverage ratio. Under the terms of the credit agreement, TEP may pay dividends so long as it maintains compliance with the credit agreement. The previous credit agreement had provided that dividends could not exceed 65% of TEP's net income. The elimination of such covenant is expected to satisfy, in part, one of the closing conditions contained in the acquisition agreement that UniSource Energy entered into with Saguro

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Acquisition Corp., by permitting TEP to dividend all of its net income to its shareholders. The credit agreement also provides that under certain circumstances, certain regulatory actions could result in a required reduction of the commitments.

The letter of credit fee of 2.35% on the new facility is significantly lower than the previous credit agreement's weighted average letter of credit fee of approximately 5%. The agreement also provides for letter of credit fronting fees of 0.25%, which will reduce to 0.125% upon the closing of Saguaro's acquisition of UniSource Energy; the previous agreement's fronting fee was 0.25%. Unreimbursed drawings on a letter of credit bear a variable rate of interest based on LIBOR plus 2.25% per annum. Interest savings in 2004 will be partially offset by the March 2004 write-off of \$2 million of fees associated with the prior facility that were capitalized and being amortized through 2006 and the amortization of \$9 million of fees associated with the entry of the new facility.

If TEP borrows under the revolving credit facility, the borrowing costs would be at a variable interest rate consisting of a spread over LIBOR or an alternate base rate. The spread is based upon a pricing grid tied to TEP's leverage. The per annum rate currently in effect on borrowings under TEP's revolving credit facility, based on its leverage, is LIBOR plus 2.25%. If TEP's leverage were to change, the spread over LIBOR could range from 1.50% to 2.25%. Also, TEP pays a commitment fee of 0.50% on the unused portion of the revolving credit facility.

In January 2004, TEP borrowed \$20 million under its revolving credit facility and repaid it within 30 days. At March 31, 2004, there were no outstanding borrowings under the revolving credit facility.

### CONTRACTUAL OBLIGATIONS

There have been no significant changes in TEP's contractual obligations or other commercial commitments from those reported in our 2003 Annual Report on Form 10-K.

### DIVIDENDS ON COMMON STOCK

TEP can pay dividends if it maintains compliance with the TEP Credit Agreement and certain financial covenants, including a covenant that requires TEP to maintain a minimum level of net worth. As of March 31, 2004, the required minimum net worth was \$351 million. TEP's actual net worth at March 31, 2004, was \$409 million. As of March 31, 2004, TEP was in compliance with the terms of the Credit Agreement.

The Citizens Settlement Agreement, as approved by the ACC, states that TEP may not pay dividends to UniSource Energy in excess of 75% of its earnings until TEP's common equity equals 40% of total capitalization (excluding capital lease obligations). As of March 31, 2004, TEP's common equity equaled 27% of total capitalization (excluding capital lease obligations).

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

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## UNISOURCE ENERGY SERVICES

### RESULTS OF OPERATIONS

UES' net income for the first three months of 2004 was \$5 million. Similar to TEP's operations, we expect UNS Electric's operations to be seasonal in nature, with peak energy demand occurring in the summer months. We also expect operations at UNS Gas to vary with the seasons, with peak energy usage occurring in the winter months.

#### UNS Electric

In the first three months of 2004, UNS Electric's customer base grew by 1%, reaching 82,409 retail customers. The table below shows UNS Electric's kWh sales and revenues for the three months ended March 31, 2004.

	Sales	Oper
Three Months Ended March 31,	2004	
	-Millions of kWh-	-Milli
Electric Retail Sales:		
Residential	153	
Commercial	120	
Industrial	43	
Other	1	
Total Electric Retail Sales	317	

UNS Electric's utility gross margin (electric revenues less purchased energy expense) was \$10 million in the first three months of 2004. Purchased energy expense was \$21 million in the first three months of 2004. UNS Electric purchases all of its energy requirements under a fixed price contract with PWCC, thus purchased energy expense is a function of kWh sales volumes. Other O&M expenses were \$5 million for the period. UNS Electric's contribution to UES' net income was \$1 million for the first quarter of 2004.

#### UNS Gas

In the first three months of 2004, UNS Gas' customer base grew by 2%, reaching 129,624 retail customers. The table below shows UNS Gas' therm sales and revenues for the three months ended March 31, 2004.

	Sales	
Three Months Ended March 31,	2004	
	-Millions of therms-	
Retail Therm Sales:		
Residential	31	
Commercial	11	
Industrial	1	
Public Authority	3	
Total Retail Therm Sales	46	
Transport	-	

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Negotiated Sales Program (NSP)

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Total Therm Sales

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UNSGas' utility gross margin (gas revenues less purchased energy expense) was \$16 million in the first three months of 2004. Purchased energy expense was \$32 million in the first three months of 2004. UNS Gas purchases all of its gas requirements under a supply and management agreement with BP Energy Company, thus purchased energy expense is a function of therm sales volumes and the price of natural gas. Other O&M expenses were \$6 million for the period. UNS Gas' contribution to UES' net income was \$4 million for the first quarter of 2004. See Factors Affecting

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Results of Operations, Rates and Regulations, Purchased Gas Adjustor, below.

## FACTORS AFFECTING RESULTS OF OPERATIONS

### COMPETITION

As required by the ACC Decision approving UniSource Energy's acquisition of the Citizens Arizona gas and electric assets, on November 3, 2003, UNS Electric filed with the ACC an application for approval of a plan to open its service territories to retail competition by December 31, 2003. The plan addresses all aspects of implementation. It includes UNS Electric's unbundled distribution tariffs for both standard offer customers and customers that choose competitive retail access, as well as Direct Access and Settlement Fee schedules. UNS Electric direct access rates for both transmission and ancillary services will be based upon its FERC Open Access Transmission Tariff. The plan is subject to review and approval by the ACC. As a result of the court decisions concerning the ACC's Retail Electric Competition Rules, we are unable to predict when and how the ACC will address this plan.

### RATES AND REGULATION

#### Purchased Gas Adjuster

UNSGas' retail rates include a Purchased Gas Adjuster (PGA) mechanism intended to address the volatility of natural gas prices and allows UNS Gas to recover its costs through a price adjuster. The PGA charge may be changed monthly based on an ACC approved mechanism that compares the twelve-month rolling average gas cost to the base cost of gas, subject to limitations on how much the price per therm may change in a twelve month period. The difference between the actual cost of UNS Gas' gas supplies and transportation contracts and that currently allowed by the ACC are deferred and recovered or repaid through the PGA mechanism. When under or over recovery trigger points are met, UNS Gas may request a PGA surcharge or surcredit with the goal of collecting or returning the amount deferred from or to customers over a twelve month period.

In September 2003, the ACC approved a PGA surcharge of \$0.1155 per therm that took effect October 1, 2003. On March 23, 2004, the ACC approved the termination of the surcharge effective October 31, 2004. The PGA balance yet to be collected, as filed with the ACC, was approximately \$4 million on March 31, 2004. The PGA balance recorded on our financial statements, which includes an accrual for unbilled revenue, was approximately \$0.2 million at March 31, 2004.

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### LIQUIDITY AND CAPITAL RESOURCES

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UES' capital requirements consist primarily of capital expenditures. UES' forecast for capital expenditures for the year ending December 31, 2004 is approximately \$37 million. UES expects to generate sufficient internal cash flows to fund its operating activities and construction expenditures during 2004. UES intends to obtain, or have made available to them through UniSource Energy, a revolving credit facility to use for working capital purposes. This facility is expected to be in place within the next five months.

#### Private Placement Notes

On August 11, 2003, UNS Gas and UNS Electric issued a total of \$160 million of aggregate principal amount of senior unsecured notes in a private placement.

The note purchase agreements for both UNS Gas and UNS Electric contain certain restrictive covenants, including restrictions on transactions with affiliates, mergers, liens to secure indebtedness, restricted payments, incurrence of indebtedness, and minimum net worth. Consolidated Net Worth, as defined by the note purchase agreements for both UNS Gas and UNS Electric, is approximately equal to the balance sheet line item, Common Stock Equity. The table below outlines the actual and required minimum net worth levels of UES, UNS Gas, and UNS Electric at March 31, 2004.

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Company	Required Net Worth	Actual Net Worth
----- -Millions of Dollars-		
UES	\$50	\$95
UNS Gas	43	57
UNS Electric	26	37

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#### CONTRACTUAL OBLIGATIONS

There have been no significant changes in UES' contractual obligations or other commercial commitments from those reported in our 2003 Annual Report on Form 10-K.

#### DIVIDENDS ON COMMON STOCK

The Citizens Settlement Agreement, as approved by the ACC, limits dividends payable by UNS Gas and UNS Electric to 75% of earnings until the ratio of common equity to total capitalization reaches 40%. At March 31, 2004, the ratio of common equity to total capitalization for UNS Gas was 37% and for UNS Electric was 38%.

The note purchase agreements for both UNS Gas and UNS Electric contain restrictive covenants including restrictions on dividends. According to the note purchase agreements, neither UNS Gas, nor UNS Electric, may declare or make distributions or dividends (restricted payments) on their common stock unless, (a) immediately after giving effect to such action no default or event of



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default would exist under such company's note purchase agreement and (b) immediately after giving effect to such action, such company would be permitted to incur an additional dollar of indebtedness under the debt incurrence test for such company.

### MILLENNIUM ENERGY HOLDINGS, INC.

#### RESULTS OF OPERATIONS

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Through affiliates, Millennium holds investments in unregulated energy and emerging technology companies. At March 31, 2004, Millennium's assets represented 5% of UniSource Energy's total assets. Millennium accounts for its investments under the consolidation method and the equity method. In some cases, Millennium is an investment's sole provider of funding. When this is the case, Millennium recognizes 100% of an investment's losses, because as sole provider of funds it bears all of the financial risk. To the extent an investment becomes profitable and Millennium has recognized losses in excess of its percentage ownership, Millennium will recognize 100% of an investment's net income until Millennium's recognized losses equal its ownership percentage of losses.

Millennium's consolidated net income was \$2 million for the three months ended March 31, 2004 compared with a net loss of \$5 million for the three months ended March 31, 2003. The \$7 million increase is primarily due to:

- o income of \$3 million, after tax, related to Millennium's investment in Haddington;
- o \$1 million of after tax income related to certain revenues at MicroSat, which Millennium recorded in the first quarter of 2004. MicroSat develops small-scale satellites under a U.S. government contract and had deferred \$2 million, before tax, of revenues earned under the contract. In February 2004, pursuant to a settlement agreement, the contract was terminated and MicroSat granted the government purpose rights to the design data and transferred all hardware assets developed under the contract to the government in exchange for the elimination of further cost-sharing obligations under the contract. These assets will be used under a new contract between MicroSat and the government, and may be used by the government for other satellite development contracts not involving MicroSat. However, MicroSat retains the right to use the design data on other government and commercial contracts. The revenues previously deferred under the original contract have been recognized by MicroSat;
- o decreased net losses from development and manufacturing costs of Global Solar's photovoltaic products;

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- o decreased net losses of less than \$1 million each from Other Millennium Investments, including Powertrusion, SES and MEG; and
- o decreased net losses due to no longer having investments in ITN and TruePricing.

The table below provides a breakdown of the net income and losses recorded by Millennium. These results exclude sales and related costs to TEP.

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	Three Months Mar 2004
	-Millions
Technology Investments	
Global Solar and IPS	
Research and Development Contract Revenues from Third Parties	\$ 0.3
Other Revenues from Third Parties	0.9
Research and Development Contract Expenses and Losses	(0.9)
Research and Development - Internal Development Expenses	(0.3)
Depreciation and Amortization Expense	(0.8)
Administrative and Other Costs	(1.5)
Income Tax Benefits	0.9
Global Solar and IPS Net Loss	(1.4)
MicroSat Net Income (Loss)	0.9
ITN Net Loss	-
Total Technology Investments Net Loss	(0.5)
Other Millennium Investments Net Income (Loss)	2.6
Total Millennium Net Income (Loss)	\$ 2.1

LIQUIDITY AND CAPITAL RESOURCES

Under the acquisition agreement described in Overview of Consolidated Businesses - Agreement and Plan of Merger above, UniSource Energy is limited as to the amount it can invest in Millennium in the future. Consequently, Millennium's ability to provide future funding for the operations of emerging companies could be affected.

Technology Investments

During the first quarter of 2004, Millennium made no contributions to Global Solar. However, UniSource Energy provided \$2 million to Global Solar under a tax sharing agreement. Millennium has no remaining funding commitments to Global Solar, other than the tax sharing agreement with UniSource Energy.

During the first quarter of 2004, Millennium funded its remaining debt commitment of \$0.5 million to IPS. Dow Corning Enterprises, Inc. (DCEI) made no additional contributions to IPS during the same time period. In April 2004, Millennium and DCEI committed to loan up to an additional \$1 million each to IPS, and each funded \$0.5 million of the commitment at that time. Millennium's remaining debt commitment to IPS is currently \$0.5 million and is contingent on IPS' attainment of certain performance criteria. Pursuant to the terms of the amended promissory notes with IPS, Millennium and DCEI have the right to convert at any time the outstanding debt amounts to equity ownership. DCEI holds warrants to purchase additional preferred shares of IPS that if exercised, could result in Millennium's ownership of IPS being reduced to as low as 59%.

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Millennium made no contributions to MicroSat during the first quarter of 2004 and has no further funding commitments to MicroSat.

As technology developers, these entities face many challenges, such as developing technologies that can be manufactured on an economic scale, technological obsolescence, competitors and possible reductions in government spending to advance technological research and development activities.

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### Other Millennium Investments

Millennium committed \$15 million in capital, excluding fees, to Haddington, a limited partnership which funds energy-related investments. A member of the UniSource Energy Board of Directors has an investment in Haddington and is a managing director of the general partner of the limited partnership. At March 31, 2004, Millennium had funded \$9 million of this commitment, none of which was funded during the first quarter of 2004. Millennium expects the balance to be funded over the next three years. In March 2004, Haddington sold one of its investments and recognized the related gain as income. Millennium recorded its share of Haddington's income in the first quarter of 2004. In April 2004, Millennium received a \$7 million distribution from Haddington related to this sale.

Millennium committed \$6 million, including fees, to Valley Ventures III, LP (Valley Ventures), a venture capital fund that invests in information technology, microelectronics and biotechnology, primarily within the southwestern U.S. Another member of the UniSource Energy Board of Directors is a general partner of the company that manages the fund. As of March 31, 2004, Millennium had funded \$2 million of this commitment, \$0.6 million of which was funded during the first quarter of 2004. Millennium expects the balance to be funded by the end of 2007.

### Millennium Commitments

Millennium's funding levels and share ownership in its investments are subject to change in the future. Millennium's outstanding equity commitments are currently limited to \$6 million to Haddington and \$4 million to Valley Ventures. Millennium's only remaining debt commitment is \$0.5 million to IPS. Millennium may commit to provide additional funding to its investments in the future.

Global Solar had commitments totaling \$1 million at March 31, 2004 and December 31, 2003 to incur future expenses relating to government contracts.

### DIVIDENDS ON COMMON STOCK

Millennium did not pay any dividends to UniSource Energy in 2003 or the first quarter of 2004.

### CRITICAL ACCOUNTING POLICIES

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In preparing financial statements under Generally Accepted Accounting Principles (GAAP), management exercises judgment in the selection and application of accounting principles, including making estimates and assumptions. UniSource Energy and TEP consider Critical Accounting Policies to be those that could result in materially different financial statement results if our assumptions regarding application of accounting principles were different. UniSource Energy and TEP describe their Critical Accounting Policies

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below. Other significant accounting policies and recently issued accounting standards are discussed in the 2003 Annual Report on Form 10-K, Note 1 of Notes to Consolidated Financial Statements - Nature of Operations and Summary of Significant Accounting Policies.

### ACCOUNTING FOR RATE REGULATION

TEP and UES generally use the same accounting policies and practices used by unregulated companies for financial reporting under GAAP. However, sometimes these principles, such as Statement of Financial Accounting Standards No. 71, Accounting for the Effects of Certain Types of Regulation (FAS 71), require special accounting treatment for regulated companies to show the effect of regulation. For example, in setting TEP's and UES' retail rates, the ACC may not allow TEP or UES to currently charge their customers to recover certain expenses, but instead requires that these expenses be charged to customers in the future. In this situation, FAS 71 requires that TEP and UES defer these items and show them as regulatory assets on the balance sheet until TEP and UES are allowed to charge their customers. TEP and UES then amortize these items as expense to the income statement as these charges are recovered from customers. Similarly, certain revenue items may be deferred as regulatory liabilities, which are also eventually amortized to the income statement as rates to customers are reduced.

The conditions a regulated company must satisfy to apply the accounting policies and practices of FAS 71 include:

- o an independent regulator sets rates;
- o the regulator sets the rates to recover specific costs of delivering service; and
- o the service territory lacks competitive pressures to reduce rates below the rates set by the regulator.

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### IMPLICATIONS OF DISCONTINUING APPLICATION OF FAS 71

#### TEP

Upon approval by the ACC of a settlement agreement (TEP Settlement Agreement) in November 1999, TEP discontinued application of FAS 71 for its generation operations. TEP continues to apply FAS 71 to its regulated operations, which include the transmission and distribution portions of its business.

TEP's regulatory assets, net of regulatory liabilities, totaled \$274 million at March 31, 2004. Regulatory assets of \$22 million are not presently included in rate base and consequently are not earning a return on investment.

TEP regularly assesses whether it can continue to apply FAS 71 to its regulated operations. If TEP stopped applying FAS 71 to these operations, it would write off the related balances of its regulatory assets as an expense and its regulatory liabilities as income on its income statement. Based on the regulatory asset balances, net of regulatory liabilities, at March 31, 2004, if TEP had stopped applying FAS 71 to its remaining regulated operations, it would have recorded an extraordinary after-tax loss of \$165 million. While regulatory orders and market conditions may affect cash flows, TEP's cash flows would not be affected if it stopped applying FAS 71 unless a regulatory order limited its ability to recover the cost of its regulatory assets.

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UES

UES' regulatory liabilities, net of regulatory assets, totaled \$2 million at March 31, 2004. If UES stopped applying FAS 71 to its regulated operations, it would write off the related balances of its regulatory assets as an expense and its regulatory liabilities as income on its income statement. Based on the regulatory liability balances, net of regulatory assets, at March 31, 2004, if UES had stopped applying FAS 71 to its regulated operations, it would have recorded an extraordinary after-tax gain of \$1 million. UES' cash flows would not be affected if it stopped applying FAS 71 unless a regulatory order limited its ability to recover the cost of its regulatory assets.

### ACCOUNTING FOR ASSET RETIREMENT OBLIGATIONS

TEP has identified legal obligations to retire generation plant assets specified in land leases for its jointly-owned Navajo and Four Corners Generating Stations. TEP also has certain environmental obligations at the San Juan Generating Station. TEP has estimated that its share of these obligations will be approximately \$38 million at the date of retirement. As of March 31, 2004 and December 31, 2003, TEP had accrued \$1.3 million and \$1.2 million for the decommissioning of its generating facilities. This amount is recorded as an accrued asset retirement obligation on the UniSource Energy and TEP balance sheets.

TEP has various transmission and distribution lines that operate under land leases and rights of way that contain end dates and restorative clauses. TEP operates its transmission and distribution lines as if they will be operated in perpetuity and would continue to be used or sold without land remediation. A final retirement occurs when an entire transmission or distribution line is permanently removed from service. Interim retirements occur as components of the system are replaced. As a result, TEP is not recognizing the costs of final removal of the transmission and distribution lines in the financial statements. As of March 31, 2004 and December 31, 2003, TEP had accrued \$62 million and \$60 million for the net cost of removal for the interim retirements from its transmission, distribution and general plant. The amount is shown as a regulatory liability.

Upon adoption of FAS 143 on January 1, 2003, TEP recorded an asset retirement obligation of \$38 million at its net present value of \$1 million, increased depreciable assets by \$0.1 million for asset retirement costs, reversed \$113 million of costs previously accrued for final removal from accumulated depreciation, reversed previously recorded deferred tax assets by \$44 million and recognized the cumulative effect of accounting change as a gain of \$112 million (\$67 million net of tax).

### UES, MILLENNIUM AND UED

UES has various transmission and distribution lines that operate under land leases and rights of way that contain end dates and restorative clauses. UES operates its transmission and distribution lines as if they will be operated in perpetuity and would continue to be used or sold without land remediation. A final retirement occurs when an entire transmission or distribution line is permanently removed from service. Interim retirements occur as components of the

system are replaced. As a result, UES is not recognizing the cost of final removal of the transmission and distribution lines in the financial statements.

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As of March 31, 2004 and December 31, 2003, UES had accrued \$1 million for the net cost of removal for interim retirements from its transmission, distribution and general plant. The amount is shown as a regulatory liability.

Millennium and UED have no asset retirement obligations.

### TEP - PAYMENT DEFAULTS AND ALLOWANCES FOR DOUBTFUL ACCOUNTS

We record an allowance for doubtful accounts when we determine that an account receivable will not be collected. As a result of payment defaults made by market participants in California, TEP's collection shortfall from the CPX and CISO was approximately \$9 million for sales made in 2000 and \$7 million for sales made in 2001. Prior to 2003 and since December 31, 2001, TEP had an allowance for doubtful accounts recorded for \$8 million, or 50% of these uncollected amounts based on the amount TEP believed would be collected. In the first quarter of 2003, as a result of a FERC order, TEP estimated that \$6 million of its \$16 million receivable will be collected. Therefore, in the first quarter of 2003, TEP increased its reserve for sales to the CPX and the CISO by \$2 million by recording a reduction of wholesale revenues. The amount that TEP ultimately collects would have an impact on earnings if the amount received is more or less than the \$6 million TEP has on its balance sheet. If TEP collects all of the \$16 million, pre-tax income will increase by \$10 million. If TEP does not collect any of the \$16 million, pre-tax income will decrease by \$6 million. In addition, TEP has cash collateral of approximately \$1 million on deposit in an escrow account with the CPX, which is currently unavailable to TEP due to the CPX's bankruptcy stay.

TEP's reserve for electric wholesale accounts receivable on its balance sheet was approximately \$10 million at both March 31, 2004 and December 31, 2003.

### PENSION AND OTHER POSTRETIREMENT BENEFIT PLAN ASSUMPTIONS

We record plan assets, obligations, and expenses related to pension and other postretirement benefit plans based on actuarial valuations. These valuations include key assumptions on discount rates, expected returns on plan assets, compensation increases and health care cost trend rates. These actuarial assumptions are reviewed annually and modified as appropriate. The effect of modifications is generally recorded or amortized over future periods. We believe that the assumptions used in recording obligations under the plans are reasonable based on prior experience, market conditions and the advice of plan actuaries.

#### TEP

TEP discounted its future pension plan obligations using a rate of 6.25% at December 31, 2003, compared with 6.75% at December 31, 2002. TEP discounted its other postretirement plan obligations using a rate of 5.5% at December 31, 2003, compared with 6.75% at December 31, 2002. TEP determines the discount rate annually based on the rates currently available on high-quality, long-term bonds. TEP looks to bonds that receive one of the two highest ratings given by a recognized rating agency and are expected to be available during the period to maturity of the pension benefits. In selecting the appropriate rate, TEP also considers the durations of plan obligations.

The pension liability and future pension expense both increase as the discount rate is reduced. A decrease in the discount rate results in an increase in the projected benefit obligation (PBO) and the service cost component of pension expense. Additionally, the recognized actuarial loss is significantly impacted by a reduction in the discount rate. Since the PBO increases with the decrease in discount rate, the obligation is that much larger than would normally occur due to normal growth of the plan. This leads to an actuarial loss

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(or a greater actuarial loss than would occur in the absence of the discount rate change), which is amortized over future periods leading to a greater expense. The resulting change in the interest cost component of pension expense is dependent on the effect that the change in the discount rate has on the PBO and will vary based on employee demographics. The effect of the lower rate used to calculate the interest cost is offset to some degree by a larger obligation. The relative magnitude of these two changes determines whether interest cost will increase or decrease. For TEP's pension plans, a 25 basis point decrease in the discount rate would increase the accumulated benefit obligation (ABO) by approximately \$5 million and the related plan expense for 2004 by approximately \$1 million. A similar increase in the discount rate would decrease the ABO by approximately \$4 million and the related plan expense for 2004 by approximately \$1 million. For TEP's plan for other postretirement benefits, a 25 basis point change in the discount rate would increase or decrease the accumulated postretirement benefit obligation (APBO) by approximately \$2 million. A 25 basis point change in the discount rate would not have a significant impact on the related plan expense for 2004.

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TEP calculates the market-related value of plan assets using the fair value of plan assets on the measurement date. At December 31, 2003 and 2002, TEP assumed its plans' assets would generate a long-term rate of return of 8.75%. In establishing its assumption as to the expected return on plan assets, TEP reviews the plans' asset allocation and develops return assumptions for each asset class based on advice from an investment consultant and the plans' actuary that includes both historical performance analysis and forward looking views of the financial markets. Pension expense increases as the expected rate of return on plan assets decreases. A 25 basis point change in the expected return on plan assets would not have a significant impact on pension expense for 2004.

TEP recorded a minimum pension liability of approximately \$4 million at December 31, 2003, compared with \$7 million at December 31, 2002. Improved stock market conditions offset a further reduction in the assumed discount rate.

Based on the above assumptions, TEP will record pension expense of approximately \$8 million and other postretirement benefit expense of \$6 million ratably throughout 2004. TEP will make required pension plan contributions of \$5 million in 2004. TEP's other postretirement benefit plan is not funded. TEP expects to make benefit payments to retirees under the postretirement benefit plan of approximately \$3 million in 2004.

TEP increased the initial health care cost trend rate used in valuing its postretirement benefit obligation to 12.1% at December 31, 2003. Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A 1% increase in assumed health care cost trend rates would increase the postretirement benefit obligation by approximately \$5 million and the related plan expense by approximately \$1 million. A similar decrease in assumed health care cost trend rates would decrease the postretirement benefit obligation by approximately \$5 million and the related plan expense by less than \$1 million.

UES

Concurrent with the acquisition of the Arizona gas and electric system assets from Citizens on August 11, 2003, UES established a pension plan for substantially all of its employees. UES did not assume the pension obligation for employees' years of service with Citizens. UES performed an actuarial valuation, as of the date of acquisition, to determine its pension expense for

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the balance of 2003. A discount rate of 6.5% was assumed based on rates available at that date and the duration of plan obligations.

UES discounted its future pension plan obligations using a rate of 6.25% at December 31, 2003. For UES' pension plan, a 25 basis point change in the discount rate would have minimal effect on either the ABO or the related pension expense. UES recorded a minimum pension liability of approximately \$1 million at December 31, 2003. UES will record pension expense of \$1 million in 2004. The pension plan is not yet funded but all required contributions will be made in accordance with minimum funding standards. UES will make a pension plan contribution of \$1 million in 2004.

On the acquisition date, UES assumed the obligation to provide postretirement benefits for a small population of former Citizens employees, both active and retired. The obligation has been recorded at a discounted value of \$2 million using a discount rate of 5.25%. The plan is not funded. UES does not expect postretirement medical benefit expenses to have a material impact on its operations.

### ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND TRADING ACTIVITIES

A derivative financial instrument or other contract derives its value from another investment or designated benchmark. TEP's, UES' and MEG's derivative activities are described fully in UniSource Energy and TEP's 2003 Annual Report on Form 10-K.

TEP has a natural gas supply agreement under which it purchases all of its gas requirements at spot market prices from Southwest Gas Corporation (SWG). TEP also has agreements to purchase power that are priced using spot market gas prices. These contracts meet the definition of normal purchases and are not required to be marked to market. In the first quarter of 2004, in an effort to minimize price risk on these purchases, TEP entered into commodity price swap agreements under which TEP purchases gas at fixed prices and simultaneously sells gas at spot market prices. The spot market price in the swap agreements is tied to the same index as the purchases under the SWG and purchased power contracts. These swap agreements, which will expire during the summer months of 2004 through 2006, were entered into with the goal of locking in fixed prices on at least 45% and not more than 80% of TEP's expected summer monthly gas risk prior to entering into the month. The swap agreements are marked to market on a monthly basis; however, since the agreements satisfy the requirements for cash flow hedge accounting, the unrealized gains and losses are recorded in

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Other Comprehensive Income, a component of Common Stock Equity, rather than being reflected in the income statement.

TEP manages the risk of counterparty default by performing financial credit reviews, setting limits, monitoring exposures, requiring collateral when needed, and using a standardized agreement which allows for the netting of current period exposures to and from a single counterparty.

Because of the complexity of derivatives, the FASB established a Derivatives Implementation Group (DIG). To date, the DIG has issued more than 100 interpretations to provide guidance in applying FAS 133. As the DIG or the FASB continues to issue interpretations, TEP, UNS Gas and UNS Electric may change the conclusions they have reached and, as a result, the accounting treatment and financial statement impact could change in the future.



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The market prices used to determine fair values for TEP's and MEG's derivative instruments are estimated based on various factors including broker quotes, exchange prices, over the counter prices and time value.

TEP's and MEG's derivative activities are reported as follows:

- o TEP's net unrealized and realized gains and losses on forward sales contracts are components of Electric Wholesale Sales;
- o TEP's net unrealized and realized gains and losses on forward purchase contracts are components of Purchased Power;
- o TEP's net unrealized gains and losses on commodity price swaps are included in Other Comprehensive Income, which is a component of Common Stock Equity; and
- o MEG's net unrealized and realized gains and losses on trading activities are components of Other Operating Revenues. Although MEG's realized gains and losses on trading activities are reported net on UniSource Energy's income statement, the related cash receipts and cash payments are reported separately on UniSource Energy's statement of cash flows.

The net pre-tax unrealized gains and losses from TEP's forward contracts were less than \$1 million for each of the three month periods ended March 31, 2004 and 2003. The net pre-tax realized and unrealized gains and losses from MEG's trading activities were also less than \$1 million for each of the three month periods ended March 31, 2004 and 2003. The net pre-tax unrealized gains and losses from TEP's commodity swap agreements recorded as cash flow hedges and included in Other Comprehensive Income were just over \$1 million as of March 31, 2004. TEP had no material cash flow hedges as of December 31, 2003.

TEP's commodity swap agreements currently satisfy the requirements for cash flow hedge accounting and are considered to be highly effective in offsetting changes in the fair market value of the gas contracts being hedged. The cash flow hedges are being assessed on an ongoing basis to ensure they continue to qualify for hedge accounting. If the hedges become ineffective in the future, the amounts included in Other Comprehensive Income will be reversed and recorded as unrealized gains and losses in the income statement.

TEP's derivative assets and liabilities are reported in Other Current Assets and Other Current Liabilities on TEP and UniSource Energy's balance sheets. The fair value of TEP's derivative assets was \$1 million at March 31, 2004 and the fair value of TEP's derivative liabilities was less than \$1 million at December 31, 2003. MEG's trading assets and liabilities are reported in Trading Assets and Trading Liabilities on UniSource Energy's balance sheet. The fair value of MEG's trading assets, including its Emissions Allowance inventory, was \$49 million at March 31, 2004 and \$22 million at December 31, 2003. The fair value of MEG's trading liabilities was \$44 million at March 31, 2004 and \$19 million at December 31, 2003.

Beginning January 1, 2004, the settlement of forward purchase and sales contracts that do not result in physical delivery are recorded net as a component of Electric Wholesale Sales in TEP's income statement. For the three months ended March 31, 2004, \$1 million in sales were netted against \$1 million in purchases, resulting in a small net gain.

See Market Risks - Commodity Price Risk in Item 3.

### UNBILLED REVENUE

TEP's and UES' retail revenues include an estimate of MWhs/therms

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delivered but unbilled at the end of each period. Unbilled revenues are dependent upon a number of factors that require management's judgment including estimates of retail sales and customer usage patterns. The unbilled revenue is estimated by comparing the estimated

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MWhs/therms delivered to the MWhs/therms billed to TEP and UES retail customers. The excess of MWhs/therms delivered over MWhs/therms billed is then allocated to the retail customer classes based on estimated usage by each customer class. TEP and UES then record revenue for each customer class based on the various bill rates for each customer class. Due to the seasonal fluctuations of TEP's actual load, the unbilled revenue amount increases during the spring and summer months and decreases during the fall and winter months. The unbilled revenue amount for UES gas sales increases during the fall and winter months and decreases during the spring and summer months, whereas, the unbilled revenue amount for UES electric sales increases during the spring and summer months and decreases during the fall and winter months.

During the second quarter of 2004, we determined that the kWh information used to estimate kWhs delivered to TEP's customers was generally understated. Additionally, we determined that TEP's existing method of pricing computed unbilled kWh sales quantities among customer classes was weighting usage by lower-priced customers too heavily and weighting usage by higher-priced customers too lightly. For TEP, the price paid by customers varies from a low of 3.7 cents per kWh for interruptible industrial load to a high of 13 cents per kWh for small commercial customers, so that allocations among customer classes are a significant element of unbilled revenues. Effective with the second quarter of 2004, we changed the estimation methodology used to quantify unbilled kWh sales and price the computed unbilled kWh sales quantities to more accurately reflect actual usage and restated prior periods.

Under the revised estimation methodology, unbilled sales are estimated for the month by reviewing the meter reading schedule and determining the number of billed and unbilled kWhs for each cycle. Current month unbilled kWhs are allocated by customer class. New unbilled revenue amounts are recorded and unbilled revenue estimates from the prior month are reversed. The primary difference between the prior estimation methodology and the current methodology results from the reversal of the prior month's accrued unbilled revenue rather than a methodology that had the effect of reversing unbilled kWhs, and a more precise application of the current rates by customer class to kWhs unbilled at the end of each month.

### PLANT ASSET DEPRECIABLE LIVES - TEP AND UES

We calculate depreciation expense based on our estimate of the useful lives of our plant assets. The estimated useful lives, and resulting depreciation rates, used to calculate depreciation expense for the transmission and distribution businesses of both UES and TEP have been approved by the ACC in prior rate decisions. Depreciation rates for transmission and distribution cannot be changed without ACC approval; however, TEP's rates may change in the future as a result of the TEP General Rate Case to be filed in June 2004. We are currently reviewing the estimated useful lives of all our assets due to a variety of factors including the construction of Springerville Unit 3 and the related environmental upgrades being made to Springerville Unit 2, new information received from the operators of the remote generating stations, and information received in connection with an analysis of FAS 143 retirement

obligations.

The estimated remaining useful lives of TEP's generating facilities are based on management's best estimate of the economic life of the units. These estimates are based on engineering estimates, economic analysis, and statistical analysis of TEP's past experience in maintaining the stations. Individual depreciation periods vary from plant to plant; however, we estimate that annual depreciation expense would decrease by \$10 million, \$15 million, \$19 million or \$21 million if the remaining useful lives of all our steam generation units were increased by five, ten, fifteen or twenty years, respectively. For the first three months of 2004, depreciation expense related to generation assets was \$9 million, and our generation assets are currently depreciated over periods ranging from 23 to 70 years from the original in-service dates.

#### DEFERRED TAX VALUATION

We record deferred tax liabilities for amounts that will increase income taxes on future tax returns. We record deferred tax assets for amounts that could be used to reduce income taxes on future tax returns. We record a valuation allowance, or reserve, for the deferred tax asset amount that we may not be able to use on future tax returns. We estimate the valuation allowance based on our interpretation of the tax rules, prior tax audits, tax planning strategies, scheduled reversal of deferred tax liabilities, and projected future taxable income.

At March 31, 2004 and December 31, 2003, UniSource Energy and the Millennium entities had a valuation allowance of \$9 million relating to net operating losses generated by the Millennium entities. In the future, if UniSource Energy and the Millennium entities determine that all or a portion of the losses may be used on tax returns, then UniSource Energy and the Millennium entities would reduce the valuation allowance and recognize a tax benefit of up to \$9 million. The primary factor that could cause the Millennium entities to recognize a tax benefit would be a change in expected future taxable income.

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In the future, if UniSource Energy and TEP determine that it is probable that TEP will not be able to use all or a portion of its net operating loss and investment tax credit carryforward amounts, then UniSource Energy and TEP would record additional valuation allowance and recognize tax expense. Factors that could cause TEP to record a valuation allowance would be a change in expected future taxable income or a change in tax filing status due to the proposed acquisition. See Outlook and Strategies - Agreement and Plan of Merger, above.

#### NEW ACCOUNTING PRONOUNCEMENTS

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The FASB recently issued the following Statements of Financial Accounting Standards (FAS) and FASB Interpretations (FIN):

- o FIN 46, Consolidation of Variable Interest Entities, was issued in January 2003, and was subsequently revised in December 2003 (FIN 46R). The primary objectives of FIN 46R are to provide guidance on the identification of entities for which control is achieved through means other than through voting rights (variable interest entities) and to determine when and which business enterprises

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should consolidate the variable interest entity (primary beneficiary). FIN 46R requires that both the primary beneficiary and all other enterprises with a significant variable interest make additional disclosures. For public companies, the revised FIN 46R is effective for financial periods ending after March 15, 2004. The adoption of FIN 46R did not and is not expected to have a significant impact on our financial statements.

- o FAS 132, Employers' Disclosures about Pensions and Other Postretirement Benefits (revised 2003), was issued by the FASB in December 2003. FAS 132 requires additional disclosures about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans beyond those in the original Statement 132 which it replaces. FAS 132, as revised, is effective for fiscal years ending after December 15, 2003. The revised disclosure requirements are included in Note 12 of Notes to Consolidated Financial Statements.

In August 2003, the Emerging Issues Task Force (EITF) published Issue No. 03-11, Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, and Not "Held for Trading Purposes" as Defined in EITF Issue No. 02-3 (EITF 03-11). EITF 03-11 discusses whether realized gains and losses should be shown gross or net in the income statement for contracts that are not held for trading purposes, as defined in EITF 02-3, but are derivatives subject to FAS 133. Determining whether realized gains and losses on derivative contracts not held for trading purposes should be reported in the income statement on a gross or net basis is a matter of judgment that depends on the relevant facts and circumstances with respect to the various activities of the entity. Retroactive application of EITF 03-11 is not required. Beginning January 1, 2004, the realized gains and losses on derivative instruments that are not held for trading purposes but are eventually net settled are shown net in the income statement. The impact of adopting EITF 03-11 was immaterial as of March 31, 2004.

### SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS

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This Quarterly Report on Form 10-Q contains forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. UniSource Energy and TEP are including the following cautionary statements to make applicable and take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 for any forward-looking statements made by or for UniSource Energy or TEP in this Quarterly Report on Form 10-Q. Forward-looking statements include statements concerning plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements that are not statements of historical facts. Forward-looking statements may be identified by the use of words such as "anticipates," "estimates," "expects," "intends," "plans," "predicts," "projects," and similar expressions. From time to time, we may publish or otherwise make available forward-looking statements of this nature. All such forward-looking statements, whether written or oral, and whether made by or on behalf of UniSource Energy or TEP, are expressly qualified by these cautionary statements and any other cautionary statements which may accompany the forward-looking statements. In addition, UniSource Energy and TEP disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of this report.

Forward-looking statements involve risks and uncertainties, which could cause actual results or outcomes to differ materially from those expressed in

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the forward-looking statements. We express our expectations, beliefs and projections in good faith and believe them to have a reasonable basis. However, we make no assurances that management's

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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 other parts of this report:

1. Effects of restructuring initiatives in the electric industry and other energy-related industries.
2. Effects of competition in retail and wholesale energy markets.
3. Changes in economic conditions, demographic patterns and weather conditions in our retail service areas.
4. Supply and demand conditions in wholesale energy markets, including volatility in market prices and illiquidity in markets, which are affected by a variety of factors. These factors include the availability of generating capacity in the western U.S., including hydroelectric resources, weather, natural gas prices, the extent of utility restructuring in various states, transmission constraints, environmental regulations and cost of compliance, FERC regulation of wholesale energy markets, and economic conditions in the western U.S.
5. The creditworthiness of the entities with which we transact business or have transacted business.
6. Changes affecting our cost of providing electrical service including changes in fuel costs, generating unit operating performance, scheduled and unscheduled plant outages, interest rates, tax laws, environmental laws, and the general rate of inflation.
7. Changes in governmental policies and regulatory actions with respect to financing and rate structures.
8. Changes affecting the cost of competing energy alternatives, including changes in available generating technologies and changes in the cost of natural gas.
9. Changes in accounting principles or the application of such principles to our businesses.
10. Changes in the depreciable lives of our assets.
11. Market conditions and technological changes affecting UniSource Energy's unregulated businesses.
12. Ability to successfully integrate UES' businesses and achieve expected earnings.
13. Unanticipated changes in future liabilities relating to employee benefit plans due to changes in market values of its retirement

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- plan assets and health care costs.
14. The outcome of any ongoing litigation.
  15. Ability to obtain financing through debt and/or equity issuance, which can be affected by various factors, including interest rate fluctuations and capital market conditions.
  16. Ability to develop and operate Springerville Generating Station Unit 3 and achieve expected cost savings.
  17. Ability to obtain necessary approvals and satisfy the other closing conditions contained in the acquisition agreement, so that the acquisition of UniSource Energy by an affiliate of Saguaro Utility can occur in a timely manner.

### ITEM 3. - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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The information contained in this Item updates, and should be read in conjunction with, information included in Part II, Item 7A in UniSource Energy and TEP's Annual Report on Form 10-K for the year ended December 31, 2003, in addition to the interim condensed consolidated financial statements and accompanying notes presented in Items 1 and 2 of this Form 10-Q.

We are exposed to various forms of market risk. Changes in interest rates, returns on marketable securities, and changes in commodity prices may affect our future financial results. The market risks resulting from changes in interest rates and returns on marketable securities have not changed materially from the market risks reported in the 2003 Annual

Report on Form 10-K . For additional information concerning risk factors, including market risks, see Safe Harbor for Forward-Looking Statements, above.

#### Risk Management Committee

We have a Risk Management Committee responsible for the oversight of commodity price risk and credit risk related to the wholesale energy marketing activities of TEP, the emissions and coal trading activities of MEG, and the fuel procurement activities at TEP and UES. Our Risk Management Committee consists of officers from the finance, accounting, legal, wholesale marketing, and the generation operations departments of UniSource Energy. To limit TEP's, UES' and MEG's exposure to commodity price risk, the Risk Management Committee sets trading and hedging policies and limits, which are reviewed frequently to respond to constantly changing market conditions. To limit TEP's, UES' and MEG's exposure to credit risk, the Risk Management Committee reviews counterparty credit exposure, as well as credit policies and limits on a quarterly basis and as needed.

#### Commodity Price Risk

We are exposed to commodity price risk primarily relating to changes in

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the market price of electricity, natural gas, coal and Emission Allowances.

TEP

To manage its exposure to energy price risk, TEP enters into forward contracts to buy or sell energy at a specified price and future delivery period. Generally, TEP commits to future energy sales based on expected excess generating capability, forward prices and generation costs, using a diversified market approach to provide a balance between long-term, mid-term and spot energy sales. TEP generally enters into forward energy and natural gas purchases during its summer peaking period to ensure it can meet its load and reserve requirements and account for other contract and resource contingencies. TEP also enters into limited forward purchases and sales to optimize its resource portfolio and take advantage of locational differences in price. These positions are managed on both a volumetric and dollar basis and are closely monitored using risk management policies and procedures overseen by the Risk Management Committee. For example, the risk management policies dictate that TEP can not take a short position in the third quarter and must have owned generation backing up all forward sales positions at the time the sale is made.

The majority of TEP's forward contracts are considered to be "normal purchases and sales" of energy and are not considered to be derivatives under Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (FAS 133). TEP records revenues on its "normal sales" and expenses on its "normal purchases" in the period in which the energy is delivered. From time to time, however, TEP enters into forward contracts that meet the definition of a derivative under FAS 133. When TEP has derivative forward contracts, it marks them to market using actively quoted prices obtained from brokers for the appropriate energy product. TEP believes that these broker quotations used to calculate the mark-to-market values represent accurate measures of the fair values of TEP's positions. The net pre-tax unrealized gains and losses from TEP's forward electricity contracts were less than \$1 million for each of the three month periods ended March 31, 2004 and 2003. This demonstrates the limited derivative forward contract activity conducted by TEP and the limited impact on TEP's operating results and financial condition.

TEP has two purchased power agreements for the period 2003 through 2006. During the first quarter of 2004, TEP purchased approximately 2,700 MWh under these contracts; energy purchased under these agreements is adjusted for changes in the price of natural gas.

TEP is also subject to commodity price risk from changes in the price of natural gas. TEP typically uses generation from its facilities fueled by natural gas to meet the summer peak demands of its retail customers and to meet local reliability needs. Due to its increasing seasonal gas usage, TEP hedges a portion of its natural gas purchases with fixed price contracts for a maximum of three years, and purchases its remaining gas needs in the spot and short-term markets through its supplier Southwest Gas Corporation (SWG).

In the first quarter of 2004, the average price of natural gas was \$5.02 per MMBtu compared with \$5.76 per MMBtu in the first quarter of 2003. Natural gas prices remained high throughout 2003 and into 2004 with continued demand, storage and production concerns. The increase in the regional supply of gas-generated energy and the completion of a 500-kV transmission connection, however, allowed TEP to decrease use of its less efficient gas generation units in favor of more economical purchases of energy in the wholesale market. TEP's generation output fueled by natural gas was approximately 12,060 MWh, or less than 1% of total generation in the first quarter of 2004, compared with approximately 103,689 MWh, or 4% of total generation in 2003.

UES

UES is also subject to commodity price risk, primarily from the changes in the price of natural gas purchased for its UNS Gas customers. This risk is mitigated through the PGA mechanism in UNS Gas' retail rates which provides an adjustment to recover the actual costs of gas and transportation. UNS Gas further reduces this risk by purchasing forward fixed price contracts for a portion of its projected gas needs under its Price Stabilization Plan. UNS Gas purchases between 45% and 80% of its estimated gas needs in this manner.

UNS Electric is not exposed to commodity price risk for its purchase of electricity as it has a fixed price full-requirements supply agreement with PWCC through May 2008.

MEG

During the fourth quarter of 2001, MEG began managing and trading Emission Allowances, coal and related instruments. We manage the market risk of this line of business by setting notional limits by product, as well as limits to the potential change in fair market value under a 33% change in price or volatility. We closely monitor MEG's trading activities, which include swap agreements, options and forward contracts, using risk management policies and procedures overseen by the Risk Management Committee. MEG marks its trading positions to market on a daily basis using actively quoted prices obtained from brokers and options pricing models for positions that extend through 2007. As of March 31, 2004 and December 31, 2003, the fair value of MEG's trading assets combined with Emission Allowances it holds in escrow was \$49 million and \$22 million, respectively. The fair value of MEG's trading liabilities was \$44 million at March 31, 2004 and \$19 million at December 31, 2003. During the first three months of 2004, MEG reflected a \$1.6 million unrealized gain and a \$1.4 million realized loss on its income statement, compared with an unrealized gain of \$1.7 million and a realized loss of \$2.1 million in the first three months of 2003.

Unrealized Gain (Loss) of MEG's Trading  
- Millions of Dollars -

Source of Fair Value At March 31, 2004	Maturity 0 - 6 mos.	Maturity 6 - 12 mos.	Maturity over 1 yr.
Prices actively quoted	\$ (3)	\$ (2)	\$ -
Prices provided by other external sources	-	-	-
Prices based on models and other valuation methods	5	2	1
Total	\$ 2	\$ -	\$ 1

Credit Risk

UniSource Energy is exposed to credit risk in its energy-related marketing and trading activities related to potential nonperformance by counterparties. We manage the risk of counterparty default by performing



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financial credit reviews, setting limits monitoring exposures, requiring collateral when needed, and using a standard agreement which allows for the netting of current period exposures to and from a single counterparty. Despite such mitigation efforts, there is a potential for defaults by counterparties. In the fourth quarter of 2000 and the first quarter of 2001, TEP was affected by payment defaults by SCE and PG&E for amounts owed to the CPX and CISO. In the fourth quarter of 2001, Enron defaulted on amounts owed to TEP for energy sales.

We calculate counterparty credit exposure by adding any outstanding receivable (net of amounts payable if a netting agreement exists) to the mark-to-market value of any forward contracts. As of March 31, 2004, TEP's total credit exposure related to its wholesale marketing activities (excluding defaulted amounts owed by the CPX, the CISO and Enron), was approximately \$6 million and MEG's total credit exposure related to its trading activities was \$17 million. TEP and MEG's credit exposure is diversified across approximately 30 counterparties. Approximately \$3 million of TEP's exposure is to non-investment grade companies.

UniSource Energy is also exposed to credit risk related to the sale of assets owned by Nations Energy Corporation (Nations Energy). In September 2001, Nations Energy sold its 26% equity interest in a power project located in Curacao, Netherlands Antilles to Mirant Curacao Investments, Ltd. (Mirant Curacao) a subsidiary of Mirant Corporation (Mirant). Nations Energy received \$5 million in cash and an \$11 million note receivable from Mirant Curacao. The note was recorded at its net present value of \$8 million using an 8% discount rate, the discount being recognized as interest income

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over the five-year life of the note. As of March 31, 2004, Nations Energy's receivable from Mirant Curacao is approximately \$9.7 million. The note is included in Investments and Other Property - Other on UniSource Energy's balance sheet. Payments on the note receivable are expected as follows: \$2 million in July 2004, \$4 million in July 2005, and \$5 million in July 2006. The note is guaranteed by Mirant Americas, Inc., a subsidiary of Mirant. On July 14, 2003, Mirant, Mirant Americas, Inc. and various other Mirant companies filed for Chapter 11 bankruptcy protection. Mirant Curacao was not included in the Chapter 11 filings. Based on a review of the projected cash flows for the power project, it appears Mirant Curacao will have sufficient future cash flows to pay the note receivable and any applicable interest. However, we cannot predict the ultimate outcome that Mirant's bankruptcy will have on the collectibility of the note from Mirant Curacao. Nations Energy will continue to evaluate the collectibility of the receivable, but currently expects to collect the note in its entirety and has not recorded any reserve for this note.

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#### ITEM 4. - CONTROLS AND PROCEDURES

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Except as noted below with respect to unbilled revenues, UniSource Energy and TEP have disclosure controls and procedures to ensure that material information recorded, processed, summarized and reported in their filings with the SEC is on an accurate and timely basis. Management of UniSource Energy and TEP, with the participation of the principal executive officer and principal financial officer of UniSource Energy and TEP have evaluated these disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of December 31, 2003. Based on

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such evaluation, with the exception of the unbilled revenue matter discussed below, the principal executive officer and principal financial officer of UniSource Energy and TEP have concluded that such disclosure controls and procedures were, as of such date, effective at ensuring that material information is recorded, processed, summarized and reported accurately and within the time periods specified by the SEC's rules and forms.

There has been no change in UniSource Energy or TEP's internal control over financial reporting that occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect UniSource Energy' or TEP's internal control over financial reporting except as described below.

During the second quarter of 2004, we determined that we had a material weakness in internal control over TEP's existing methodology of estimating unbilled revenues. As a result, we restated the financial statements included in this Form 10-Q.

During the second quarter of 2004, we determined that the kWh information used to estimate kWhs delivered to TEP's customers was, in general, understated. Additionally, we determined that TEP's existing method of pricing computed unbilled kWh sales quantities among customer classes was weighting usage by lower-priced customers too heavily and weighting usage by higher-priced customers too lightly. For TEP, the price paid by customers varies from a low of 3.7 cents per kWh for interruptible industrial load to a high of 13 cents per kWh for small commercial customers, so that allocations among customer classes are a significant element of unbilled revenues. Effective with the second quarter of 2004, we changed the estimation methodology used to quantify unbilled kWh sales and price the computed unbilled kWh sales quantities to more accurately reflect actual usage and restated prior periods.

In addition to restating our financial statements, subsequent to the date of our evaluation, we implemented changes to improve controls over estimating unbilled revenue.

Also during the second quarter of 2004, we engaged an independent consulting firm to test various aspects of our general information technology controls primarily in the area of network access controls. The consultant made several recommendations, which we implemented by the end of July 2004. While we are not aware of any impacts to date on our financial reporting from not having had these controls in place before, we believe these improvements to controls will enhance data integrity controls subsequent to the date of our evaluation.

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## PART II - OTHER INFORMATION

### ITEM 1. - LEGAL PROCEEDINGS

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There have been no significant changes in our legal proceedings from those reported in our 2003 Annual Report on Form 10-K, other than those listed below:

Withdrawal of Litigation Concerning the Proposed Acquisition Agreement

On March 17, 2004, plaintiffs withdrew two shareholder derivative

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lawsuits, McBride v. Pignatelli, et al. and Zetooney v. Pignatelli, et al., filed in the Superior Court of the State of Arizona on November 24, 2003, the same day that UniSource Energy announced details of its proposed acquisition by Saguaro Utility Group, L.P. UniSource Energy paid no consideration in connection with the withdrawal of the lawsuits. In these two lawsuits, which were virtually identical, the plaintiffs alleged that UniSource Energy's Board of Directors, in its consideration and approval of the acquisition agreement, breached its fiduciary duty to UniSource Energy's shareholders in approving the acquisition agreement.

We discuss other legal proceedings in Note 9 of Notes to Condensed Consolidated Financial Statements.

### ITEM 4. - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

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UniSource Energy conducted a special meeting of shareholders on March 29, 2004. At that meeting, shareholders voted to approve the acquisition agreement entered into on November 21, 2003 between UniSource Energy and Saguaro Acquisition Corp., which is a wholly-owned indirect subsidiary of Saguaro Utility Group, L.P.

There were 34,019,401 shares outstanding on the record date. The table below summarizes the voting results.

	Shares Voted	% of Shares Outstanding	% of Votes Cast
For	23,737,447	69.8%	96.9%
Against	707,947	2.1%	2.9%
Abstain	59,711	0.1%	0.2%
<b>Total Shares Voted</b>	<b>24,505,105</b>	<b>72.0%</b>	<b>100.0%</b>

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### ITEM 5. - OTHER INFORMATION

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#### ADDITIONAL FINANCIAL DATA

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

	3 Months Ended March 31, 2004	12 Months March 2004
Ratio of Earnings to Fixed Charges	1.07	1.6

NON-GAAP MEASURE

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### Adjusted EBITDA

Adjusted EBITDA represents EBITDA excluding the cumulative effect of accounting change which is a non-cash item. EBITDA is earnings before interest, taxes, depreciation and amortization. Adjusted EBITDA is presented here as a measure of liquidity because it can be used as an indication of a company's ability to incur and service debt and is commonly used as an analytical indicator in our industry. Adjusted EBITDA measures presented may not be comparable to similarly titled measures used by other companies. Adjusted EBITDA is not a measurement presented in accordance with United States generally accepted accounting principles (GAAP), and we do not intend Adjusted EBITDA to represent cash flows from operations as defined by GAAP. Adjusted EBITDA should not be considered to be an alternative to cash flows from operations or any other items calculated in accordance with GAAP or an indicator of our operating performance.

UniSource Energy and TEP view Adjusted EBITDA, a non-GAAP financial measure, as a liquidity measure. The most directly comparable GAAP measure to Adjusted EBITDA is Net Cash Flows from Operating Activities.

### Adjusted EBITDA and Net Cash Flows from Operating Activities

(Restated - See Note 18 in the Financial Statements)

	UniSource Energy	
	Three Months Ended	
	March 31,	
	2004	2003
	-Millions	
Adjusted EBITDA	\$ 101	\$ 52
Net Cash Flows from Operations	\$42	\$ 10

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### Reconciliation of Adjusted EBITDA to Cash Flows from Operations

(Restated - See Note 18 in the Financial Statements)

	UniSource Energy	
	Three Months Ended	
	March 31,	
	2004	2003
	-Millions	
Adjusted EBITDA (1)	\$ 101	\$ 52
Net Cash Flows from Operations		
Less: Income Taxes	6	(9)
Less: Total Interest Expense	43	40
Changes in Assets and Liabilities and		
Other Non-Cash Items	(10)	(11)

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Net Cash Flows from Operating Activities	\$42	\$ 10
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	UniSource Energy	
	-----	
	Three Months Ended	
	March 31,	
	2004	2003
-----		
Net Income	\$ 6	\$ 52
Amounts from the Income Statements:		
Less: Cumulative Effect of Accounting Change	-	67
Plus: Income Taxes	6	(9)
Plus: Total Interest Expense	43	40
Plus: Depreciation and Amortization	35	31
Plus: Amortization of Transition Recovery Asset	9	4
Plus: Depreciation included in Fuel and Other O&M Expense*	2	1
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Adjusted EBITDA	\$ 101	\$ 52
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\*See Supplemental Cash Flow Information in Note 16 of the Notes to Condensed Consolidated Financial Statements.

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SEC REPORTS AVAILABLE ON UNISOURCE ENERGY'S WEBSITE

UniSource Energy and TEP make available their annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after they electronically file them with, or furnish them to, the SEC. These reports are available free of charge through UniSource Energy's website address: <http://www.unisourceenergy.com>. A link from UniSource Energy's website to these SEC reports is accessible at the UniSource Energy main page.

Information contained at UniSource Energy's website is not part of any report filed with, or furnished to, the SEC by UniSource Energy or TEP.

The SEC also maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The SEC website address is <http://www.sec.gov>. Interested parties may also read and copy any materials UniSource Energy and TEP file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. Information on the operation of the Public Reference Room is available by calling the SEC at 1-800-SEC-0030.

ITEM 6. - EXHIBITS AND REPORTS ON FORM 8-K

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(a) Exhibits.  
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See Exhibit Index.

(b) Reports on Form 8-K.

- UniSource Energy and TEP Form 8-K, dated January 28, 2004, furnished pursuant to Item 9 "Regulation FD Disclosure," providing reconciliations of non-GAAP financial measures in connection with a proposed refinancing of TEP's credit facilities.
- UniSource Energy and TEP Form 8-K, dated February 17, 2004, furnished pursuant to Item 12 "Disclosure of Results of Operations and Financial Condition," announcing fourth quarter and year-end 2003 earnings for UniSource Energy and TEP.
- UniSource Energy and TEP Form 8-K, dated March 31, 2004, filed pursuant to Item 5 "Other Events," describing the refinancing of TEP's credit facility and the results of the UniSource Energy special shareholders' meeting held on March 29, 2004. Also filed TEP's new credit facility and supplemental indenture as exhibits, pursuant to Item 7 "Financial Statements and Exhibits."
- UniSource Energy and TEP Form 8-K, dated May 4, 2004, furnished pursuant to Item 12 "Disclosure of Results of Operations and Financial Condition," announcing first quarter 2004 earnings for UniSource Energy and TEP.

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SIGNATURES

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

UNISOURCE ENERGY CORPORATION  
(Registrant)

Date: August 24, 2004

/s/ Kevin P. Larson

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Kevin P. Larson  
Vice President and Principal  
Financial Officer

TUCSON ELECTRIC POWER COMPANY  
(Registrant)

Date: August 24, 2004

/s/ Kevin P. Larson

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Kevin P. Larson  
Vice President and Principal

EXHIBIT INDEX

- 12 - Computation of Ratio of Earnings to Fixed Charges - TEP.
- 15 - Letter regarding unaudited interim financial information.
- 31(a) - Certification Pursuant to Section 302 of the Sarbanes-Oxley Act - UniSource Energy, by James S. Pignatelli.
- 31(b) - Certification Pursuant to Section 302 of the Sarbanes-Oxley Act - UniSource Energy, by Kevin P. Larson.
- 31(c) - Certification Pursuant to Section 302 of the Sarbanes-Oxley Act - TEP, by James S. Pignatelli.
- 31(d) - Certification Pursuant to Section 302 of the Sarbanes-Oxley Act - TEP, by Kevin P. Larson.
- \*32 - Statements of Corporate Officers (pursuant to Section 906 of the Sarbanes-Oxley Act of 2002).

\*Pursuant to Item 601(b)(32)(ii) of Regulation S-k, this certificate is not being filed for purposes of Section 18 of the Securities Act of 1934.