

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

ANNUAL REPORT MAILING LABEL – MAKE CHANGES AS NECESSARY

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UNS Gas, Inc.
Attn: Melissa Morales
PO Box 711, Mailstop HQE910
Tucson, AZ 85702

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

Please click here if pre-printed Company name on this form is not your current Company name or dba name is not included.

Please list current Company name including dba here:

ANNUAL REPORT
Gas

FOR YEAR ENDING

12	31	2019
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FOR COMMISSION USE

ANN 02	19
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COMPANY INFORMATION

Company Name (Business Name) _____ UNS Gas, Inc. _____

Mailing Address _____ P.O.Box 711, Mailstop HQE910 _____
(Street)

_____ Tucson _____ Arizona _____ 85702 _____
(City) (State) (Zip)

_____ 520-884-3650 _____ 520-884-3601 _____ N/A _____
Telephone No. (Include Area Code) Fax No. (Include Area Code) Cell No. (Include Area Code)

Email Address _____ JoSmith@uns.com _____

Local Office Mailing Address _____ P.O. Box 711, Mailstop HQE910 _____
(Street)

_____ Tucson _____ Arizona _____ 85702 _____
(City) (State) (Zip)

_____ 520-884-3650 _____ 520-623-7711 _____
Local Customer Service Phone No. (Include Area Code) (1-800 or other long distance Customer Service Phone No.)

Email Address _____ N/A _____ **Website address** www.tep.com

MANAGEMENT INFORMATION

Regulatory Contact:

Management Contact: _____ Jo Smith _____ VP, Public Policy _____
(Name) (Title)

_____ P.O. Box 711, Mailstop HQE910 _____ Tucson _____ Arizona _____ 85702 _____
(Street) (City) (State) (Zip)

_____ 520-884-3650 _____ 520-884-3601 _____ N/A _____
Telephone No. (Include Area Code) Fax No. (Include Area Code) Cell No. (Include Area Code)

Email Address _____ JoSmith@uns.com _____

On Site Manager: _____ Martin _____
(Name)

_____ 2901 W. Shamrell Blvd., Suite 110 _____ Flagstaff _____ Arizona _____ 86001 _____
(Street) (City) (State) (Zip)

_____ 928-226-2266 _____ 520-779-5338 _____ N/A _____
Telephone No. (Include Area Code) Fax No. (Include Area Code) Cell No. (Include Area Code)

Email Address: manya@uesaz.com

Statutory Agent: Todd Hixon
(Name)

P.O. Box 711, Mailstop HQE910 Tucson Arizona 85702
(Street) (City) (State) (Zip)

520-884-3667 520-884-2601 N/A
Telephone No. (Include Area Code) Fax No. (Include Area Code) Cell No. (Include Area Code)

Attorney: Amy Welander
(Name)

P.O. Box 711, Mailstop HQE910 Tucson Arizona 85702
(Street) (City) (State) (Zip)

520-884-3655 N/A N/A
Telephone No. (Include Area Code) Fax No. (Include Area Code) Cell No. (Include Area Code)

Email Address _____

OWNERSHIP INFORMATION

Check the following box that applies to your company:

- | | |
|---|--|
| <input type="checkbox"/> Sole Proprietor (S) | <input checked="" type="checkbox"/> C Corporation (C) (Other than Association/Co-op) |
| <input type="checkbox"/> Partnership (P) | <input type="checkbox"/> Subchapter S Corporation (Z) |
| <input type="checkbox"/> Bankruptcy (B) | <input type="checkbox"/> Association/Co-op (A) |
| <input type="checkbox"/> Receivership (R) | <input type="checkbox"/> Limited Liability Company |
| <input type="checkbox"/> Other (Describe) _____ | |

COUNTIES SERVED

Check the box below for the county/ies in which you are certificated to provide service:

- | | | |
|--|---|--|
| <input checked="" type="checkbox"/> APACHE | <input type="checkbox"/> COCHISE | <input checked="" type="checkbox"/> COCONINO |
| <input type="checkbox"/> GILA | <input type="checkbox"/> GRAHAM | <input type="checkbox"/> GREENLEE |
| <input type="checkbox"/> LA PAZ | <input type="checkbox"/> MARICOPA | <input checked="" type="checkbox"/> MOHAVE |
| <input checked="" type="checkbox"/> NAVAJO | <input type="checkbox"/> PIMA | <input type="checkbox"/> PINAL |
| <input checked="" type="checkbox"/> SANTA CRUZ | <input checked="" type="checkbox"/> YAVAPAI | <input type="checkbox"/> YUMA |
| <input type="checkbox"/> STATEWIDE | | |

SERVICES AUTHORIZED TO PROVIDE

Check the following box(es) for the services that you are authorized to provide:

Gas

Natural Gas

Propane

Other (Specify) _____

STATISTICAL INFORMATION

GAS UTILITIES ONLY

Total number of customers	160,153 _____
Residential	147,235 _____
Commercial	12,872 _____
Industrial	41 _____
Irrigation	5 _____
Resale	0 _____
Total therms sold	157,317,728 _____ therms
Residential	85,868,927 _____
Commercial	40,797,050 _____
Industrial	30,638,636 _____
Irrigation	13,115 _____
Resale	0 _____

UNS Gas, Inc.

88 East Broadway Blvd. | Post Office Box 711 | HQE910 | Tucson, AZ 85702-1702

May 21, 2020

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5/21/2020 01:42 PM

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

Compliance Section
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007

Re: Utilities Division Annual Report For the year ending December 31, 2019
UNS Gas, Inc.

Dear Sir or Madam:

In lieu of Notarization of the Verification and Sworn Statements, the below is substituted.

Under penalty of perjury, I declare that the foregoing is true and correct to the best of my knowledge and belief.



Frank P. Marino
Sr. Vice President & Chief Financial Officer

**VERIFICATION
AND
SWORN STATEMENT
Intrastate Revenues Only**

**RECEIVED
BY EMAIL**

4/15/2020, 12:11 PM

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

VERIFICATION

STATE OF Arizona

I, THE UNDERSIGNED
OF THE

COUNTY OF (COUNTY NAME) Pima
NAME (OWNER OR OFFICIAL) TITLE Frank P. Marino, Vice President & Chief Financial Officer
COMPANY NAME UNS Gas Inc.

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING

MONTH	DAY	YEAR
12	31	2019

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENT OF TITLE 40, ARTICLE 8, SECTION 40-401, ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS DURING CALENDAR YEAR 2019 WAS:

Arizona Intrastate Gross Operating Revenues Only (\$) \$ 124,135,080

(THE AMOUNT IN BOX ABOVE
INCLUDES \$ 10,905,924
IN SALES TAXES BILLED, OR COLLECTED)

****REVENUE REPORTED ON THIS PAGE MUST INCLUDE SALES TAXES BILLED OR COLLECTED. IF FOR ANY OTHER REASON, THE REVENUE REPORTED ABOVE DOES NOT AGREE WITH TOTAL OPERATING REVENUES ELSEWHERE REPORTED, ATTACH THOSE STATEMENTS THAT RECONCILE THE DIFFERENCE. (EXPLAIN IN DETAIL)**

SIGNATURE OF OWNER OR OFFICIAL

520-745-3448
TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF

THIS _____ DAY OF

(SEAL)

COUNTY NAME
MONTH .20__

SIGNATURE OF NOTARY PUBLIC

MY COMMISSION EXPIRES _____

**VERIFICATION
AND
SWORN STATEMENT
RESIDENTIAL REVENUE
INTRASTATE REVENUES ONLY**

**RECEIVED
BY EMAIL**

4/15/2020, 12:11 PM
ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

STATE OF ARIZONA

COUNTY OF (COUNTY NAME) Pima	
NAME (OWNER OR OFFICIAL) Frank P. Marino	TITLE Sr. VP & CFO
COMPANY NAME UNS Gas Inc.	

I, THE UNDERSIGNED

OF THE

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING

MONTH	DAY	YEAR
12	31	2019

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENTS OF TITLE 40, ARTICLE 8, SECTION 40-401.01, ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS RECEIVED FROM RESIDENTIAL CUSTOMERS DURING CALENDAR YEAR 2019 WAS:

ARIZONA INTRASTATE GROSS OPERATING REVENUES
\$ 76,939,781

(THE AMOUNT IN BOX AT LEFT INCLUDES \$ 6,759,567 IN SALES TAXES BILLED, OR COLLECTED)

*RESIDENTIAL REVENUE REPORTED ON THIS PAGE MUST INCLUDE SALES TAXES BILLED.

SIGNATURE OF OWNER OR OFFICIAL

TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF

THIS DAY OF

(SEAL)

MY COMMISSION EXPIRES

NOTARY PUBLIC NAME	
COUNTY NAME	
MONTH	.20__

SIGNATURE OF NOTARY PUBLIC

FINANCIAL INFORMATION

Attach to this annual report a copy of the companies' year-end (Calendar Year 2019) financial statements. If you do not compile these reports, the Utilities Division will supply you with blank financial statements for completion and filing. **ALL INFORMATION MUST BE ARIZONA-SPECIFIC AND REFLECT OPERATING RESULTS IN ARIZONA.**

UNS Gas, Inc.
FINANCIAL STATEMENTS

December 31, 2019





Deloitte & Touche LLP
2901 North Central Avenue
Suite 1200
Phoenix, AZ 85012-2799
USA
Tel: 1 602 234 5100
Fax: 1 602 234 5186
www.deloitte.com

INDEPENDENT AUDITORS' REPORT

To the Stockholder and the Board of Directors of
UNS Gas, Inc.

We have audited the accompanying balance sheets of UNS Gas, Inc. (the "Company") as of December 31, 2019 and 2018, and the related statements of income, changes in stockholder's equity, and cash flows for the years then ended, and the related notes (collectively referred to as the "financial statements").

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2019 and 2018, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

Phoenix, Arizona
February 21, 2020

UNS GAS, INC.
STATEMENTS OF INCOME
(Amounts in thousands)

	Years Ended December 31,	
	2019	2018
Operating Revenues	\$ 118,352	\$ 113,365
Operating Expenses		
Purchased Energy	52,974	54,050
Decrease to Reflect PGA Recovery Treatment	(1,228)	(893)
Total Purchased Energy	51,746	53,157
Operations and Maintenance	28,115	26,981
Depreciation	11,964	11,537
Amortization	(863)	(953)
Taxes Other Than Income Taxes	4,565	4,467
Total Operating Expenses	95,527	95,189
Operating Income	22,825	18,176
Other Income (Expense)		
Interest Expense	(4,748)	(4,828)
Allowance For Borrowed Funds	17	19
Allowance For Equity Funds	14	27
Other, Net	(223)	99
Total Other Income (Expense)	(4,940)	(4,683)
Income Before Income Tax Expense	17,885	13,493
Income Tax Expense	4,228	3,190
Net Income	\$ 13,657	\$ 10,303

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

UNS GAS, INC.
STATEMENTS OF CASH FLOWS

(Amounts in thousands)

	Years Ended December 31,	
	2019	2018
Cash Flows from Operating Activities		
Net Income	\$ 13,657	\$ 10,303
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation Expense	11,964	11,537
Amortization Expense	(863)	(953)
Amortization of Debt Issuance Costs	90	90
Deferred Income Taxes	1,808	1,336
Pension and Other Postretirement Benefits Expense	1,016	1,016
Pension and Other Postretirement Benefits Funding	(1,184)	(1,032)
Allowance for Equity Funds Used During Construction	(14)	(27)
Regulatory Deferral, ACC Refund Order	674	(245)
Changes in Current Assets and Current Liabilities:		
Accounts Receivable	(2,425)	303
Materials and Supplies	122	(1,255)
Regulatory Assets	(493)	(312)
Other Current Assets	(134)	58
Accounts Payable and Accrued Charges	(3,005)	1,605
Regulatory Liabilities	(1,702)	(2,236)
Other, Net	805	490
Net Cash Flows—Operating Activities	20,316	20,678
Cash Flows from Investing Activities		
Capital Expenditures	(25,402)	(21,679)
Contributions in Aid of Construction	3,100	2,370
Net Cash Flows—Investing Activities	(22,302)	(19,309)
Cash Flows from Financing Activities		
Proceeds from Borrowings, Revolving Credit Facility	5,000	—
Dividend Paid to Parent	(5,000)	(8,000)
Other	96	1,403
Net Cash Flows—Financing Activities	96	(6,597)
Net Decrease in Cash and Cash Equivalents	(1,890)	(5,228)
Cash and Cash Equivalents, Beginning of Period	7,630	12,858
Cash and Cash Equivalents, End of Period	\$ 5,740	\$ 7,630

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

UNS GAS, INC.
BALANCE SHEETS

(Amounts in thousands, except share data)

	December 31,	
	2019	2018
ASSETS		
Utility Plant		
Plant in Service	\$ 388,008	\$ 371,691
Construction Work in Progress	2,456	1,615
Total Utility Plant	390,464	373,306
Accumulated Depreciation and Amortization	(81,319)	(75,966)
Total Utility Plant, Net	309,145	297,340
Current Assets		
Cash and Cash Equivalents	5,740	7,630
Accounts Receivable, Net	21,566	19,140
Materials and Supplies	2,454	2,576
Regulatory Assets	3,481	2,890
Derivative Instruments	837	1,232
Other	706	572
Total Current Assets	34,784	34,040
Regulatory and Other Assets		
Regulatory Assets	7,680	8,387
Derivative Instruments	908	412
Other	2,917	455
Total Regulatory and Other Assets	11,505	9,254
Total Assets	\$ 355,434	\$ 340,634

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

(Continued)

UNS GAS, INC.
BALANCE SHEETS

(Amounts in thousands, except share data)

	December 31,	
	2019	2018
CAPITALIZATION AND OTHER LIABILITIES		
Capitalization		
Common Stock Equity:		
Common Stock (No Par Value, 1,000 Shares Authorized, 1,000 Shares Outstanding as of December 31, 2019 and 2018)	\$ 67,978	\$ 67,978
Retained Earnings	45,700	37,043
Total Common Stock Equity	113,678	105,021
Long-Term Debt, Net	94,444	94,403
Total Capitalization	208,122	199,424
Current Liabilities		
Borrowings Under Credit Agreement	5,000	—
Accounts Payable	11,420	14,321
Accrued Taxes Other than Income Taxes	4,885	4,371
Accrued Employee Expenses	1,586	1,660
Accrued Interest	1,810	1,791
Regulatory Liabilities	5,414	6,936
Customer Deposits	2,196	2,333
Derivative Instruments	2,901	3,230
Other	2,899	2,619
Total Current Liabilities	38,111	37,261
Regulatory and Other Liabilities		
Deferred Income Taxes, Net	32,679	30,560
Regulatory Liabilities	64,387	63,300
Customer Advances for Construction	4,760	4,863
Pension and Other Postretirement Benefits	4,235	3,790
Derivative Instruments	977	1,436
Lease Liabilities and Other	2,163	—
Total Regulatory and Other Liabilities	109,201	103,949
Commitments and Contingencies		
Total Capitalization and Other Liabilities	\$ 355,434	\$ 340,634

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

(Concluded)

UNS GAS, INC.
STATEMENTS OF CHANGES IN STOCKHOLDER'S EQUITY

(Amounts in thousands)

	<u>Common Stock</u>	<u>Retained Earnings</u>	<u>Total Stockholder's Equity</u>
Balances as of December 31, 2017	\$ 67,978	\$ 34,740	\$ 102,718
Net Income		10,303	10,303
Dividend Declared to Parent		(8,000)	(8,000)
Balances as of December 31, 2018	\$ 67,978	\$ 37,043	\$ 105,021
Net Income		13,657	13,657
Dividend Declared to Parent		(5,000)	(5,000)
Balances as of December 31, 2019	\$ 67,978	\$ 45,700	\$ 113,678

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

NOTE 1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

UNS Gas, Inc. (UNS Gas) is a regulated natural gas distribution company which services approximately 160,000 retail customers in Mohave, Yavapai, Coconino, Navajo and Santa Cruz counties in Arizona. UNS Gas is a wholly owned subsidiary of UniSource Energy Services, Inc. (UES), an intermediate holding company that is wholly owned by UNS Energy Corporation (UNS Energy). UNS Energy, a utility services holding company, is an indirect wholly owned subsidiary of Fortis Inc. (Fortis).

BASIS OF PRESENTATION

UNS Gas' financial statements and disclosures are presented in accordance with Generally Accepted Accounting Principles in the United States of America (GAAP), including specific accounting guidance for regulated operations. Certain amounts from prior periods have been reclassified to conform to the current year presentation.

Accounting for Regulated Operations

UNS Gas applies accounting standards that recognize the economic effects of rate regulation. As a result, UNS Gas capitalizes certain costs that would be recorded as expense or in Accumulated Other Comprehensive Income (AOCI) by unregulated companies. Regulatory assets represent incurred costs that have been deferred because they are probable of future recovery in rates designed to allow a regulated utility recovery of its costs of providing services and an opportunity to earn a reasonable return on its investment (Retail Rates) charged to retail customers or in rates charged to wholesale customers through transmission tariffs. Regulatory liabilities generally represent expected future costs that have already been collected from customers or amounts that are expected to be returned to customers through billing reductions in future periods.

Estimates of recovering deferred costs and returning deferred credits are based on specific ratemaking decisions or precedent for each item. Regulatory assets and liabilities are amortized consistent with the treatment in the rate setting process. UNS Gas evaluates regulatory assets and liabilities each period and believes future recovery or settlement is probable. If future recovery of costs ceases to be probable, the assets would be written off as a charge to current period earnings or AOCI. See Note 2 for additional information regarding regulatory matters.

UNS Gas applies regulatory accounting as the following conditions exist:

- An independent regulator sets rates;
- The regulator sets the rates to recover the specific enterprise's costs of providing service; and
- Rates are set at levels that will recover the entity's costs and can be charged to and collected from ratepayers.

NEW ACCOUNTING STANDARDS ISSUED AND ADOPTED

The following new authoritative accounting guidance issued by the Financial Accounting Standards Board (FASB) has been adopted as of January 1, 2019. Unless otherwise indicated, adoption of the new guidance in each instance had an insignificant impact on UNS Gas' financial position, results of operations, cash flows, and disclosures.

Leases

UNS Gas early adopted accounting guidance that requires lessees to recognize a lease liability, initially measured at the present value of future lease payments, and a right-of-use asset for all leases with a lease term greater than 12 months. The new lease standard also requires additional quantitative and qualitative disclosures for both lessees and lessors. UNS Gas applied the transition provisions of the new standard as of the adoption date and did not retrospectively adjust prior periods. In addition, UNS Gas elected a package of practical expedients that allowed it to not reassess: (i) whether existing contracts are or contain a lease; (ii) the lease classification of existing leases; or (iii) the initial direct costs for existing leases. Furthermore, UNS Gas elected a practical expedient that permitted it to not evaluate existing land easements that were not previously accounted for as leases. The new lease guidance has been applied on a prospective basis to all new or modified land easements since January 1, 2019. Finally, UNS Gas utilized the hindsight practical expedient in the transition provisions to determine the lease term. UNS Gas did not identify or record an adjustment to the opening balance of retained earnings on adoption. See Note 8 for additional disclosure about UNS Gas' leasing arrangements.

Internal-Use Software

UNS Gas early adopted accounting guidance that clarifies accounting for implementation costs incurred in a cloud computing arrangement that is a service contract. Under the new guidance, customers apply the same criteria for capitalizing implementation costs as they would for an arrangement that has a software license. The guidance also provides specific

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

requirements for the classification and presentation of the capitalized implementation costs and the related amortization of those costs. UNS Gas adopted the standard prospectively.

NEW ACCOUNTING STANDARDS ISSUED AND NOT YET ADOPTED

New authoritative accounting guidance issued by the FASB was assessed and either determined to not be applicable or is expected to have an insignificant impact on UNS Gas' financial position, results of operations, cash flows, and disclosures.

USE OF ACCOUNTING ESTIMATES

Management uses estimates and assumptions when preparing financial statements according to GAAP. These estimates and assumptions affect:

- assets and liabilities in the balance sheet at the dates of the financial statements;
- disclosures about contingent assets and liabilities at the dates of the financial statements; and
- revenues and expenses in the income statement during the periods presented.

Because these estimates involve judgments based upon management's evaluation of relevant facts and circumstances, actual results may differ from these estimates.

Contingencies

Reserves for specific legal proceedings are established when the likelihood of an unfavorable outcome is probable and the amount of loss can be reasonably estimated. Significant judgment is required in predicting the outcome of these suits and claims, many of which take years to complete. UNS Gas identifies certain other legal matters where the Company believes an unfavorable outcome is reasonably possible or no estimate of possible losses can be made. All contingencies are regularly reviewed to determine whether the likelihood of loss has changed and to assess whether a reasonable estimate of the loss or range of loss can be made.

CASH AND CASH EQUIVALENTS

UNS Gas considers all highly liquid investments with a remaining maturity of three months or less at acquisition to be cash equivalents.

ALLOWANCE FOR DOUBTFUL ACCOUNTS

UNS Gas records an allowance for doubtful accounts to reduce accounts receivable for amounts estimated to be uncollectible. The allowance is determined based on historical bad debt patterns, retail sales, and economic conditions. Accounts receivable are charged-off in the period in which the receivable is deemed uncollectible.

INVENTORY

UNS Gas values materials, supplies, and fuel inventory at the lower of weighted average cost and net realizable value. Materials and supplies consist of generation, transmission, and distribution construction and repair materials. The majority of UNS Gas' inventory will be recovered in rates charged to ratepayers. Handling and procurement costs (such as labor, overhead costs, and transportation costs) are capitalized as part of the cost of the inventory.

UTILITY PLANT

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

The cost of repairs and maintenance are expensed to Operations and Maintenance Expense on the Statements of Income as costs are incurred.

When UNS Gas retires a unit of regulated property, accumulated depreciation is reduced by the original cost plus removal costs less any salvage value. There is no impact to the income statement.

AFUDC and Capitalized Interest

AFUDC reflects the cost of debt and equity funds used to finance construction and is capitalized as part of the cost of regulated utility plant. AFUDC amounts are capitalized and amortized through depreciation expense as a recoverable cost in Retail Rates. The capitalized interest that relates to debt is recorded in Allowance For Borrowed Funds on the Statements of Income. The capitalized cost for equity funds is recorded in Allowance For Equity Funds on the Statements of Income.

The average AFUDC rates on regulated construction expenditures are included in the table below:

	2019	2018
Average AFUDC Rates	5.45%	6.58%

Depreciation

Depreciation is recorded for owned utility plant on a group method straight-line basis at depreciation rates based on the economic lives of the assets. See Note 3 for additional information regarding utility plant. The Arizona Corporation Commission (ACC) approves all depreciation rates. Depreciation rates are based on average useful lives and include estimates for salvage value and removal costs.

Below are the summarized average annual depreciation rates for all utility plant:

	2019	2018
Average Annual Depreciation Rates	2.62%	2.60%

Computer Software and Cloud Computing Costs

Costs incurred to purchase and develop internal use computer software and cloud computing arrangements that include a software license are capitalized and amortized over the estimated economic life of the product. Implementation costs incurred in a cloud computing arrangement that is a service contract are included in Regulatory and Other Assets—Other on the Balance Sheets and amortized over the life of the service agreement. Amortization expense is presented in Operations and Maintenance Expense on the Statements of Income. If the associated software is no longer useful or impaired, the carrying value is reduced and recorded as an expense on the income statement.

EVALUATION OF ASSETS FOR IMPAIRMENT

Long-lived assets and investments are evaluated for impairment whenever events or changes in circumstances indicate that an asset's carrying amount may not be recoverable. If estimated future undiscounted cash flows are less than the carrying amount, the Company estimates the fair value and records an impairment for the amount by which the carrying value exceeds the fair value. For these estimates, UNS Gas may consider data from multiple valuation methods, including data from market participants. The Company exercises judgment to: (i) estimate the future cash flows and the useful lives of long-lived assets; and (ii) determine the Company's intent to use the assets. UNS Gas' intent to use or dispose of assets is subject to re-evaluation and can change over time.

DEFERRED FINANCING COSTS

Costs to issue debt are deferred and amortized to interest expense on a straight-line basis over the life of the debt. Deferred debt issuance costs are presented in the balance sheet as a direct deduction from the carrying value of the associated debt liability. These costs include underwriters' commissions, discounts or premiums, and other costs such as legal, accounting, regulatory fees, and printing costs.

UNS Gas accounts for debt issuance costs related to credit facility arrangements as an asset.

The gains and losses on reacquired debt associated with regulated operations are deferred and amortized to interest expense over the remaining life of the original debt.

LEASES

When a contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration, a right-of-use asset and lease liability are recognized. UNS Gas measures the right-of-use asset and lease liability at the present value of future lease payments, excluding variable payments based on usage or performance. UNS Gas calculates the present value using the rate implicit in the lease or a lease-specific secured interest rate based on the lease term. UNS Gas has lease agreements with lease components (e.g., rent, real estate taxes and insurance costs) and nonlease components (e.g., common

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

area maintenance costs), which are accounted for as a single lease component. UNS Gas includes options to extend a lease in the lease term when it is reasonably certain that the option will be exercised. Leases with an initial term of twelve months or less are not recorded on the balance sheet. UNS Gas discloses variable lease costs of short term leases as short term lease cost.

OPERATING REVENUES

UNS Gas earns the majority of its revenues from the sale of natural gas to retail customers based on regulator-approved tariff rates. Most of the Company's contracts have a single performance obligation, the delivery of natural gas. UNS Gas satisfies the performance obligation over time as natural gas is delivered and control is transferred to the customer. The Company bills for natural gas sales based on the reading of meters on a systematic basis throughout the month. In general, UNS Gas' contracts have payment terms of 10 to 20 days from the date the bill is rendered. UNS Gas considers any payment not received by the due date delinquent and charges the customer a late payment fee. No component of the transaction price is allocated to unsatisfied performance obligations. See Note 4 for the disaggregation of UNS Gas' Operating Revenues.

PURCHASED GAS ADJUSTMENT CLAUSE

UNS Gas recovers actual gas costs incurred through a Purchased Gas Adjustor (PGA) mechanism that adjusts monthly. Gas cost over-recoveries are deferred as regulatory liabilities and cost under-recoveries are deferred as regulatory assets. See Note 2 for additional information regarding regulatory matters.

ENERGY EFFICIENCY PROGRAMS

UNS Gas is required to implement cost-effective Demand Side Management (DSM) programs to comply with the ACC's Energy Efficiency Standards (EE Standards). The EE Standards provide regulated utilities a DSM surcharge to recover from retail customers the costs to implement DSM programs. The EE Standards require increasing annual targeted retail therm savings equal to 6% by 2020.

The DSM surcharges collected above or below the costs incurred to implement the plans are deferred and reflected in the balance sheet as a regulatory liability or asset. UNS Gas recognizes DSM surcharge revenue in Operating Revenues on the Statements of Income in amounts necessary to offset recognized qualifying expenditures.

TAXES OTHER THAN INCOME TAXES

UNS Gas acts as a conduit or collection agent for sales taxes, utility taxes, franchise fees, and regulatory assessments. Trade receivables are recorded as the Company bills customers for these taxes and assessments. Simultaneously, liabilities payable to governmental agencies are recorded in the balance sheet for these taxes and assessments. These amounts are not reflected in the income statement.

INCOME TAXES

Due to the difference between GAAP and income tax laws, many transactions are treated differently for income tax purposes than for financial statement presentation purposes. Temporary differences are accounted for by recording deferred income tax assets and liabilities on the balance sheet. These assets and liabilities are recorded using enacted income tax rates expected to be in effect when the deferred tax assets and liabilities are realized or settled. UNS Gas reduces deferred tax assets by a valuation allowance when, in the opinion of management, it is more likely than not that some portion, or the entire deferred income tax asset, will not be realized.

Tax benefits are recognized when it is more likely than not that a tax position will be sustained upon examination by the tax authorities based on the technical merits of the position. The tax benefit recorded is the largest amount that is more than 50% likely to be realized upon ultimate settlement with the tax authority, assuming full knowledge of the position and all relevant facts. Interest expense accruals relating to income tax obligations are recorded in Interest Expense on the Statements of Income.

UNS Gas records income tax liabilities based on its taxable income as reported in the consolidated tax return of FortisUS Inc., a Fortis intermediate holding company (FortisUS).

PENSION AND OTHER POSTRETIREMENT BENEFITS

UES sponsors a noncontributory, defined benefit pension plan for substantially all employees of UES. Benefits are based on years of service and average compensation. The Company also provides limited healthcare and life insurance benefits for retirees.

UES recognizes the underfunded status of the defined benefit pension plan as a liability in the balance sheet. The underfunded status is measured as the difference between the fair value of the pension plan's assets and the projected benefit obligation for

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

the pension plan. UES recognizes a regulatory asset to the extent these future costs are probable of recovery in the rates charged to retail customers. The Company expects recovery of these costs over the estimated service lives of employees.

Pension and other postretirement benefit expenses are determined by actuarial valuations based on assumptions that the Company evaluates annually. See Note 10 for additional information regarding the employee benefit plan.

FAIR VALUE

As defined under GAAP, fair value is the price that would be received to sell an asset or paid to transfer a liability between market participants in the principal market or in the most advantageous market when no principal market exists. Adjustments to transaction prices or quoted market prices may be required in illiquid or disorderly markets in order to estimate fair value. Different valuation techniques may be appropriate under the circumstances to determine the value that would be received to sell an asset or paid to transfer a liability in an orderly transaction. Market participants are assumed to be independent, knowledgeable, able and willing to transact an exchange, and not under duress. Nonperformance or credit risk is considered in determining fair value. Considerable judgment may be required in interpreting market data used to develop the estimates of fair value. Accordingly, estimates of fair value presented herein are not necessarily indicative of the amounts that could be realized in a current or future market exchange. See Note 12 for additional information regarding fair value.

DERIVATIVE INSTRUMENTS

The Company uses various physical and financial derivative instruments, including forward contracts, financial swaps, and call and put options, to: (i) meet forecasted load and reserve requirements; (ii) reduce exposure to energy commodity price volatility; and (iii) hedge interest rate risk exposure. Derivative instruments that do not meet the normal purchase or normal sale scope exception are recognized as either assets or liabilities on the balance sheet and are measured at fair value. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation.

Commodity derivatives used in normal business operations that are settled by physical delivery, among other criteria, are eligible for, and may be designated as normal purchases or normal sales. Normal purchases or normal sales contracts are not recorded at fair value and settled amounts are recognized as cost of energy on the income statement.

For derivatives designated as hedging contracts, UNS Gas formally assesses, at inception, whether the hedging contract is highly effective in offsetting changes in the hedged item. Also, UNS Gas formally documents hedging activity by transaction type and risk management strategy. UNS Gas had no contracts designated as hedging contracts as of December 31, 2019 and 2018.

For derivatives not designated as hedging contracts, the settled amount is generally included in regulated rates. Accordingly, the net unrealized gains and losses associated with interim price movements on contracts that are accounted for as derivatives and probable of inclusion in regulated rates are recorded as regulatory assets and liabilities. See Note 12 for additional information regarding derivative instruments.

SUBSEQUENT EVENTS

UNS Gas evaluates events or transactions that occur after the balance sheet date but before the financial statements are issued for potential recognition or disclosure in the financial statements. UNS Gas has evaluated subsequent events through February 21, 2020, the date the financial statements were issued.

NOTE 2. REGULATORY MATTERS

The ACC regulates portions of utility accounting practices and rates of UNS Gas, which includes: (i) rates charged to retail customers; (ii) the issuance of securities, transactions with affiliated parties; and (iii) other utility matters. The ACC also enacts other regulations and policies that can affect the Company's business decisions and accounting practices. The Federal Energy Regulatory Commission (FERC) regulates the terms and rates of wholesale transport and purchases of natural gas for UNS Gas.

2012 RATE ORDER

Provisions of the 2012 Rate Order, which were effective May 1, 2012, included, but are not limited to a base rate increase of \$2.7 million.

FEDERAL TAX LEGISLATION

In December 2017, the ACC opened a docket requesting that all regulated utilities submit proposals to address passing the benefits of the Tax Cuts and Jobs Act (TCJA) through to customers. In 2018, the ACC approved UNS Gas' proposal to return savings from the Company's federal corporate income tax rate under the TCJA to its customers through a combination of customer bill credits and a regulatory liability deferral that reflects the return of a portion of the savings (ACC Refund Order). The ACC Refund Order represents the reduction in the federal corporate income tax rate and an estimate of Excess Deferred Income Tax (EDIT) amortization that will be trued-up annually for actuals. The bill credit was designed to return the refund amount to customers based on forecasted therm sales for the calendar year. Any over or under collected amounts are deferred to a regulatory liability or asset and will be used to adjust the following year's bill credit amounts. Customer bill credits are trued up annually to reflect actuals for both therm sales and EDIT amortization. UNS Gas filed an application with the ACC to establish a 2020 customer refund of \$3.1 million. The refund will be returned to customers through a combination of a customer bill credit and a regulatory liability in 2020. The customer bill credit will account for 50% of the returned savings in 2020 and through the completion of our next rate case.

The table below summarizes the regulatory asset (liability) balance related to the ACC Refund Order:

(in thousands)	Years Ended December 31,	
	2019	2018
Beginning of Period	\$ 495	\$ —
ACC Approved Refund (Reduction in Operating Revenues)	(2,921)	(2,859)
Amount Returned to Customers Through Bill Credits	2,503	3,354
Regulatory Deferral	674	—
End of Period	<u>\$ 751</u>	<u>\$ 495</u>

See Note 13 for additional information regarding the TCJA.

COST RECOVERY MECHANISMS

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

Purchased Gas Adjustor

The PGA mechanism allows UNS Gas to adjust Retail Rates to recover fluctuations in natural gas costs. UNS Gas records deferrals for recovery or refund to the extent actual natural gas costs vary from the PGA rate. The PGA rate reflects a weighted, 12-month rolling average of the natural gas costs incurred by UNS Gas. The PGA rate automatically adjusts monthly, but is restricted from rising or falling more than \$0.15 per therm in a 12-month period. UNS Gas is required to request a credit or notify the ACC if the PGA balance is over-collected by \$10.0 million or more.

The table below summarizes the PGA regulatory asset (liability) balance:

(in thousands)	Years Ended December 31,	
	2019	2018
Beginning of Period	\$ (5,856)	\$ (6,688)
Deferred Purchased Gas Costs	44,301	45,183
PGA Refunds (Recoveries) ⁽¹⁾	(43,047)	(44,351)
End of Period	<u>\$ (4,602)</u>	<u>\$ (5,856)</u>

⁽¹⁾ In October 2018, the ACC approved a PGA credit effective November 1, 2018 to April 30, 2019.

Energy Efficiency Standards

Under the EE Standards, the ACC requires natural gas utilities to implement cost-effective programs to reduce customers' energy consumption. The EE Standards require increasing cumulative annual targeted retail therm savings equal to 6% by 2020. UNS Gas is required to implement cost-effective DSM programs to comply with the ACC's EE Standards. The EE Standards provide regulated utilities a DSM surcharge to recover from retail customers the costs to implement DSM programs.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

Lost Fixed Cost Recovery Mechanism

The Lost Fixed Cost Recovery (LFCR) mechanism provides for recovery of certain non-fuel costs that would go unrecovered due to reduced retail therm sales as a result of implementing ACC-approved energy efficiency programs. UNS Gas records a regulatory asset and recognizes LFCR revenues when the amounts are verifiable regardless of when the lost retail therm sales occur. UNS Gas is required to make an annual filing with the ACC requesting recovery of LFCR revenues recognized in the prior year. The recovery is subject to a year-over-year increase cap of 1% of UNS Gas' applicable retail revenues.

The table below summarizes the LFCR revenues recognized in Operating Revenues on the Statements of Income:

(in thousands)	Years Ended December 31,	
	2019	2018
LFCR Revenues	\$ 122	\$ 133

REGULATORY ASSETS AND LIABILITIES

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

(in thousands)	December 31,	
	2019	2018
Regulatory Assets		
Pension and Other Postretirement Benefits (Note 10)	\$ 5,037	\$ 4,423
Derivatives (Note 12)	2,395	3,066
Income Taxes Recoverable through Future Rates ⁽¹⁾	2,535	2,936
Other Regulatory Assets	1,194	852
Total Regulatory Assets	11,161	11,277
Less Current Portion	3,481	2,890
Total Non-Current Regulatory Assets	\$ 7,680	\$ 8,387
Regulatory Liabilities		
Net Cost of Removal ⁽²⁾	\$ 35,451	\$ 34,145
Income Taxes Payable through Future Rates ⁽¹⁾	28,843	29,556
Purchased Gas Adjustor	4,602	5,856
Other Regulatory Liabilities	905	679
Total Regulatory Liabilities	69,801	70,236
Less Current Portion	5,414	6,936
Total Non-Current Regulatory Liabilities	\$ 64,387	\$ 63,300

⁽¹⁾ Amortized over the life of the assets. See Note 13 for additional information regarding income taxes.

⁽²⁾ Represents an estimate of the future cost of retirement net of salvage value. These are amounts collected through revenue for transmission, distribution, generation plant, and general and intangible plant which are not yet expended.

Regulatory assets are either being collected or are expected to be collected through Retail Rates. UNS Gas does not earn a return on regulatory assets. Regulatory liabilities represent items that UNS Gas either expects to pay to customers through billing reductions in future periods or plans to use for the purpose for which they were collected from customers. With the exception of over-recovered PGA costs and Income Taxes Payable through Future Rates related to EDIT balances, UNS Gas does not pay a return on regulatory liabilities.

IMPACTS OF REGULATORY ACCOUNTING

If UNS Gas determines that it no longer meets the criteria for continued application of regulatory accounting, UNS Gas would be required to write off its regulatory assets and liabilities related to those operations not meeting the regulatory accounting requirements. Discontinuation of regulatory accounting could have a material impact on UNS Gas' financial statements.

NOTE 3. UTILITY PLANT

The following table shows Plant in Service on the Balance Sheets by major class:

(\$ in thousands)	Annual Depreciation Rate ⁽¹⁾	Average Remaining Life in Years ⁽¹⁾	December 31,	
			2019	2018
Plant in Service				
Distribution Plant	2.37%	32	\$ 342,222	\$ 326,913
Transmission Plant	1.54%	45	17,542	17,542
General Plant	4.38%	0	27,860	26,844
Intangible Plant, Software Costs, and Other ⁽²⁾	Various	Various	50	58
Plant Held for Future Use	—	—	334	334
Total Plant in Service ⁽³⁾			\$ 388,008	\$ 371,691

⁽¹⁾ Represents a composite of the depreciation rates of assets within each major class of gas plant and is based on the 2011 depreciation study available for the major classes of Plant in Service.

⁽²⁾ Primarily represents miscellaneous intangible assets which are amortized over an average service life of 15 to 25 years and have an average remaining life of less than one year.

⁽³⁾ Includes plant acquisition adjustments of \$(48.3) million as of December 31, 2019 and 2018.

NOTE 4. REVENUE

UNS Gas earns the majority of its revenues from the sale of natural gas to retail customers based on regulator-approved tariff rates. The Company's contracts have a single performance obligation, the delivery of natural gas.

DISAGGREGATION OF REVENUES

The following table presents the disaggregation of UNS Gas' Operating Revenues on the Statements of Income by type of service:

(in thousands)	Years Ended December 31,	
	2019	2018
Retail	\$ 113,103	\$ 108,379
Other Services	1,777	1,805
Revenues from Contracts with Customers	114,880	110,184
Alternative Revenues	122	133
Other	3,350	3,048
Total Operating Revenues	\$ 118,352	\$ 113,365

Retail Revenues

UNS Gas' tariff-based sales to residential, commercial, and industrial customers are regulated by the ACC and recognized when natural gas is delivered at the amount of consideration that the Company expects to receive in exchange. Retail revenues include an estimate for unbilled revenues from service that has been provided but not billed by the end of an accounting period. At the end of the month, amounts of natural gas delivered since the last meter reading are estimated and the corresponding unbilled revenue is calculated using anticipated Retail Rates. Unbilled revenues are dependent upon a number of factors that require management's judgment including estimates of retail sales, customer usage patterns, and pricing. Unbilled revenues primarily increase during the fall and winter months and decrease during the spring and summer months due to the seasonal fluctuations of UNS Gas' actual load. The timing of revenue recognition, billings, and cash collections results in billed and unbilled accounts receivable balances on the balance sheet. See Note 5 for components of Accounts Receivable, Net on the Balance Sheets.

Other Services Revenues

Other Services Revenues primarily includes miscellaneous service connection fees.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

Alternative Revenues

Alternative revenue programs allow utilities to adjust future rates in response to past activities or completed events if certain criteria established by a regulator are met. UNS Gas charges customers the ACC-authorized tariff price plus separate ACC-authorized surcharges. UNS Gas has identified its LFCR mechanism as an alternative revenue. The LFCR mechanism provides for recovery of certain non-fuel costs that would go unrecovered due to reduced therm sales as a result of implementing ACC-approved energy efficiency programs. The LFCR surcharge is assessed as a percentage of the customer's bill. Revenue recognition related to the LFCR mechanism creates a regulatory asset until such time as the revenue is collected. For recovery of the LFCR regulatory asset, UNS Gas is required to file an annual LFCR adjustment request with the ACC for the LFCR revenues recognized in the prior year. The recovery is subject to a year-over-year cap of applicable retail revenues of 1%. See Note 2 for additional information regarding these cost recovery mechanisms.

Other Revenues

Other Revenues primarily includes the resale of purchased energy and derivative revenue. See Note 12 for information regarding derivative instruments.

NOTE 5. ACCOUNTS RECEIVABLE

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

(in thousands)	December 31,	
	2019	2018
Customer	\$ 9,881	\$ 8,735
Customer, Unbilled	10,793	9,638
Due from Affiliates (Note 6)	1,298	1,165
Allowance for Doubtful Accounts	(406)	(398)
Accounts Receivable, Net	\$ 21,566	\$ 19,140

NOTE 6. RELATED PARTY TRANSACTIONS

UNS Gas engages in various transactions with Fortis, UNS Energy, and affiliated subsidiaries of UNS Energy including Tucson Electric Power Company (TEP), UNS Electric, Inc. (UNS Electric), and Southwest Energy Solutions, Inc. (SES) (collectively UNS Energy Affiliates). These transactions include: (i) the sale and purchase of natural gas and transportation services; (ii) common cost allocations; and (iii) the provision of corporate and other labor-related services.

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

(in thousands)	December 31,	
	2019	2018
Receivables from Related Parties		
UNS Electric	\$ 489	\$ 422
TEP	203	741
UNS Energy	606	2
Total Due from Related Parties	\$ 1,298	\$ 1,165
Payables to Related Parties		
UNS Energy	\$ 28	\$ 540
TEP	1,657	1,352
UNS Electric	93	157
SES	40	35
Total Due to Related Parties	\$ 1,818	\$ 2,084

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

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

(in thousands)	Years Ended December 31,	
	2019	2018
Goods and Services Provided by UNS Gas to Affiliates		
Sale and Transportation of Gas, UNS Electric ⁽¹⁾	\$ 4,643	\$ 3,688
Capacity Charges, TEP ⁽¹⁾	947	588
Capacity Charges, UNS Electric ⁽¹⁾	316	196
Corporate Services, UNS Energy Affiliates ⁽²⁾	24	837
Goods and Services Provided by Affiliates to UNS Gas		
Common Costs, TEP ⁽³⁾	9,046	8,535
Supplemental Workforce, SES ⁽⁴⁾	247	111
Corporate Services, UNS Energy ⁽⁵⁾	1,174	1,209
Corporate Services, UNS Energy Affiliates ⁽²⁾	4,183	4,075
Corporate Services, Fortis Affiliates ⁽⁶⁾	5	5

- ⁽¹⁾ UNS Gas charges UNS Electric and TEP for natural gas and transportation to Black Mountain Generating Station (BMGS) and Valencia Generating Station. See Note 9 for detail of costs related to certain agreements.
- ⁽²⁾ Costs for corporate and other administrative services between UNS Energy Affiliates are directly assigned to the benefiting entity at a fully burdened cost when possible.
- ⁽³⁾ Common costs (information systems, facilities, etc.) are allocated on a cost-causative basis. The method of allocation is deemed reasonable by management and is reviewed by the ACC as part of the rate case process.
- ⁽⁴⁾ SES provides supplemental workforce and meter-reading services to UNS Gas based on related party service agreements. The charges are based on cost of services performed and deemed reasonable by management.
- ⁽⁵⁾ Costs for corporate services at UNS Energy are allocated to its subsidiaries using the Massachusetts Formula, an industry accepted method of allocating common costs to affiliated entities. UNS Gas' allocation is approximately 6% of UNS Energy's allocated costs. Corporate Services, UNS Energy includes legal, audit, and Fortis management fees.
- ⁽⁶⁾ Fortis affiliates provide non-tariffed goods and services to UNS Energy Affiliates at the higher of fully burdened cost or fair market value.

SHARE-BASED COMPENSATION

2015 Share Unit Plan

The Human Resources and Governance Committee of UNS Energy approved and UNS Energy's Board of Directors ratified the 2015 Share Unit Plan (Plan) effective January 2015. Under the Plan, key employees, including executive officers of UNS Energy and its subsidiaries, may be granted long-term incentive awards of performance-based share units (PSU) and time-based restricted share units (RSU) annually. Each PSU and RSU granted is valued based on one share of Fortis common stock traded on the Toronto Stock Exchange, converted to U.S. dollars. UNS Energy allocates the obligation and expense for this plan to its subsidiaries based on the Massachusetts Formula. UNS Energy accounts for forfeitures as they occur.

The following table represents PSUs and RSUs awarded by UNS Energy:

	2019	2018
PSUs	66,978	54,426
RSUs	33,489	27,213

The awards are classified as liability awards based on the cash settlement feature. Liability awards are measured at their fair value at the end of each reporting period and will fluctuate based on the price of Fortis' common stock as well as the level of achievement of the financial performance criteria. The awards are payable on the third anniversary of the grant date. UNS Gas' allocated share of probable payout was \$0.9 million and \$0.7 million as of December 31, 2019 and 2018, respectively.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

UNS Gas' allocated portion of compensation expense is recognized in Operations and Maintenance Expense on the Statements of Income. Compensation expense associated with unvested PSUs and RSUs is recognized on a straight-line basis over the minimum required service period in an amount equal to the fair value on the measurement date or each reporting period. UNS Gas recorded \$0.3 million and \$0.2 million in 2019 and 2018, respectively, based on its share of UNS Energy's compensation expense.

NOTE 7. DEBT AND CREDIT AGREEMENT

DEBT

Long-term debt matures more than one year from the date of the financial statements. The following table presents the components of Long-Term Debt, Net on the Balance Sheets:

(\$ in thousands)	Interest Rate	Maturity Date	December 31,	
			2019	2018
Notes				
2011 Senior Notes	5.39%	2026	\$ 50,000	\$ 50,000
2015 Senior Notes	4.00%	2045	45,000	45,000
Total Long-Term Debt ⁽¹⁾			95,000	95,000
Less Debt Issuance Costs			556	597
Total Long-Term Debt, Net			<u>\$ 94,444</u>	<u>\$ 94,403</u>

⁽¹⁾ As of December 31, 2019, all of UNS Gas' debt is unsecured.

CREDIT AGREEMENT

In October 2015, UNS Gas and UNS Electric entered into a shared unsecured credit agreement with a maturity date of October 2022 that provides for revolving credit commitment and letter of credit (LOC) facility (2015 Credit Agreement). Terms are as follows:

(in thousands)	Capacity	Sub-Limit LOC	Borrowed	Available	Weighted Average Interest Rate	Pricing ⁽²⁾	
						December 31, 2019	
Credit Facility ⁽¹⁾	\$ 100	\$ 50	\$ 40	\$ 60	2.79%	LIBOR + 1.000%	or ABR + 0.00%
(in thousands)	December 31, 2018						
Credit Facility ⁽¹⁾	\$ 100	\$ 50	\$ —	\$ 100	—%	LIBOR + 1.000%	or ABR + 0.00%

⁽¹⁾ The maximum borrowings outstanding at any one time for UNS Gas or UNS Electric under their shared agreement may not exceed 80% of the aggregate of the commitments and each is liable for only their own individual borrowings. UNS Gas and UNS Electric borrowings outstanding were \$5.0 million and \$35.0 million, respectively, as of December 31, 2019.

⁽²⁾ Interest rates and fees under the credit facility are based on a pricing grid tied to the respective entity's credit ratings.

Amounts borrowed under the 2015 Credit Agreement will be used for working capital and other general corporate purposes. An LOC will be issued from time to time to support energy procurement and hedging transactions.

As of February 21, 2020, there was \$61.0 million available under the shared revolving credit commitments and LOC facility. All borrowings outstanding belonged to UNS Electric.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

NOTE 8. LEASES

UNS Gas leases office facilities with remaining terms of three to four years. Most leases include one or more options to renew, with renewal terms that may extend a lease term for up to 20 years. Certain lease agreements include rental payments adjusted periodically for inflation or require UNS Gas to pay real estate taxes, insurance, maintenance, or other operating expenses associated with the lease premises.

UNS Gas' leases are included on the balance sheet as follows:

(in thousands)	Lease Type	December 31, 2019
Lease Assets		
Regulatory and Other Assets, Other	Operating	\$ 2,632
Lease Liabilities		
Current Liabilities, Other	Operating	588
Lease Liabilities and Other	Operating	2,065

The following table presents the components of UNS Gas' lease cost:

(in thousands)	Year Ended December 31, 2019
Operating	\$ 686
Variable	114
Short Term	6
Total Lease Cost	\$ 806

As of December 31, 2019, UNS Gas had the following future minimum lease payments, excluding payments to lessors for variable costs:

(in thousands)	Operating Leases
2020	\$ 672
2021	693
2022	685
2023	572
2024	239
Thereafter	—
Total Lease Payments	2,861
Less Imputed Interest	208
Total Lease Obligations	2,653
Less Current Portion	588
Total Non-Current Lease Obligations	\$ 2,065

The following table presents UNS Gas' lease terms and discount rate related to its leases:

	December 31, 2019
Weighted-Average Remaining Lease Term (years)	
Operating Leases	4
Weighted-Average Discount Rate	
Operating Leases	3.5%

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

The following table presents UNS Gas' cash flow information related to its leases:

(in thousands)	Year Ended December 31, 2019
Cash Paid for Amounts Included in the Measurement of Lease Liabilities	
Operating Cash Flows used for Operating Leases	\$ 600

See Note 11 for non-cash transactions that resulted in recognition of right-of-use assets in exchange for lease liabilities.

DISCLOSURES RELATED TO PERIODS PRIOR TO ADOPTION OF THE NEW LEASE STANDARD

As of December 31, 2018, future minimum lease payments were as follows:

(in thousands)	Operating Leases
2019	\$ 571
2020	512
2021	529
2022	518
2023	402
Thereafter	167
Total	\$ 2,699

Operating lease cost for year ended December 31, 2018, was \$0.8 million.

NOTE 9. COMMITMENTS AND CONTINGENCIES

COMMITMENTS

As of December 31, 2019, UNS Gas had the following unconditional minimum purchase obligations:

(in thousands)	2020	2021	2022	2023	2024	Thereafter	Total
Fuel, Including Transportation	\$ 15,912	\$ 15,585	\$ 15,564	\$ 12,212	\$ 3,648	\$ 3,947	\$ 66,868
Land Easements and Rights-of-Way ⁽¹⁾	16	38	47	45	32	2,305	2,483
Total Purchase Commitments	\$ 15,928	\$ 15,623	\$ 15,611	\$ 12,257	\$ 3,680	\$ 6,252	\$ 69,351

⁽¹⁾ These agreements contain varying terms, provisions, and expiration dates.

Fuel, Including Transportation

UNS Gas purchases natural gas from various suppliers at market prices and the costs are recoverable from customers through the PGA. UNS Gas' forward gas purchase agreements expire through the first quarter of 2021. Certain of these contracts are at a fixed price per million British thermal units (MMBtu) and others are indexed to natural gas prices, and are based on projected market prices as of December 31, 2019. UNS Gas has firm transportation agreements with capacity sufficient to meet its load requirements. These contracts expire in various years between October 2020 and March 2026 as of December 31, 2019.

Related Party Agreements

UNS Gas has related party agreements for natural gas supply and pipeline capacity with UNS Electric for BMGS and Valencia through March 2028 and October 2020, respectively. As of December 31, 2019, UNS Electric's commitment under these contracts totaled \$9.6 million and does not reduce the balance in the table above. Natural gas is supplied as needed to meet UNS Electric's load requirements. See Note 6 for more information on UNS Gas' related party transactions.

CONTINGENCIES

UNS Gas is party to a variety of legal actions arising out of the normal course of business. Plaintiffs occasionally seek punitive or exemplary damages. The Company believes such normal and routine litigation will not have a material impact on its operations or financial results.

NOTE 10. EMPLOYEE BENEFIT PLANS

PENSION BENEFIT PLAN

UNS Gas does not maintain a separate pension plan. The pension plan maintained by UES covers the majority of UNS Gas' employees. UNS Gas and UNS Electric fund the plan by contributing at least the minimum amount required under Internal Revenue Service (IRS) regulations. UES allocates net periodic benefit cost based on service cost for participating employees. UNS Gas recognizes its share of the underfunded status of the UES defined benefit pension plan as a liability in the balance sheet.

OTHER POSTRETIREMENT BENEFIT PLAN

UNS Gas provides other postretirement medical benefits for certain retirees. UNS Gas' active employees are not eligible for retiree medical benefits.

REGULATORY RECOVERY

UNS Gas records its share of changes in the pension and other postretirement defined benefit plans, not yet reflected in net periodic benefit cost, as a regulatory asset or liability, as such amounts are probable of future recovery or refund in rates charged to retail customers.

The following table presents pension and other postretirement benefit amounts (excluding tax balances) included on the balance sheet:

(in thousands)	Pension Benefits		Other Postretirement Benefits	
	December 31,			
	2019	2018	2019	2018
Regulatory Assets	\$ 4,451	\$ 3,890	\$ 586	\$ 533
Accrued Employee Expenses	—	—	(38)	(38)
Pension and Other Postretirement Benefits	(3,916)	(3,457)	(319)	(333)
Net Amount Recognized	\$ 535	\$ 433	\$ 229	\$ 162

OBLIGATIONS AND FUNDED STATUS

The Company measured the actuarial present values of all defined benefit pension and other postretirement benefit obligations as of December 31, 2019 and 2018. The table below presents the status of the UES pension plan as a whole and UES' share of the TEP other postretirement benefits plan.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

The plans have projected benefit obligations in excess of the fair value of plan assets for each period presented:

(in thousands)	Pension Benefits		Other Postretirement Benefits	
	Years Ended December 31,			
	2019	2018	2019	2018
Change in Benefit Obligation				
Beginning of Period	\$ 34,363	\$ 39,339	\$ 682	\$ 817
Actuarial (Gain) Loss	6,541	(5,552)	48	(15)
Interest Cost	1,480	1,391	26	22
Service Cost	1,894	2,085	—	—
Participant Contributions	—	—	27	33
Benefits Paid	(1,071)	(2,900)	(160)	(175)
End of Period	<u>43,207</u>	<u>34,363</u>	<u>623</u>	<u>682</u>
Change in Fair Value of Plan Assets				
Beginning of Period	27,465	30,983	5	5
Actual Return on Plan Assets	6,788	(2,526)	—	—
Benefits Paid	(1,071)	(2,900)	(160)	(175)
Employer Contributions ⁽¹⁾	2,216	1,908	132	142
Participant Contributions	—	—	27	33
End of Period	<u>35,398</u>	<u>27,465</u>	<u>4</u>	<u>5</u>
Funded Status at End of Period	<u>\$ (7,809)</u>	<u>\$ (6,898)</u>	<u>\$ (619)</u>	<u>\$ (677)</u>

⁽¹⁾ UNS Gas expects to contribute \$1.2 million to the pension plan in 2020.

As of December 31, 2019, UNS Gas' proportionate share of the pension plan's total funded status is approximately 50%.

The \$8.8 million increase in the pension benefit obligation was driven by a significant decrease in the discount rates as a result of a decrease in interest rates. The \$7.9 million increase in the pension plan assets was due to positive equity returns and fixed income returns as a result of the decline in interest rates.

The following table provides the components of UES' regulatory assets that have not been recognized as components of net periodic benefit cost as of the dates presented:

(in thousands)	Pension Benefits		Other Postretirement Benefits	
	Years Ended December 31,			
	2019	2018	2019	2018
Net Loss	\$ 10,160	\$ 8,996	\$ 1,025	\$ 977
Prior Service Benefit	—	—	(1)	(4)

The pension plan had an accumulated benefit obligation in excess of plan assets as of the dates presented:

(in thousands)	December 31,	
	2019	2018
Accumulated Benefit Obligation	\$ 36,649	\$ 29,062
Fair Value of Plan Assets	35,398	27,465

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

The Company measures service and interest costs by applying the specific spot rates along the yield curve to the plans' liability cash flows. UES' net periodic benefit plan cost includes the following components:

(in thousands)	Pension Benefits		Other Postretirement Benefits	
	Years Ended December 31,			
	2019	2018	2019	2018
Service Cost	\$ 1,894	\$ 2,085	\$ —	\$ —
Non-Service Cost				
Interest Cost	1,480	1,391	26	22
Expected Return on Plan Assets	(1,932)	(2,165)	—	—
Amortization of Prior Service Credit	—	—	(3)	(3)
Amortization of Net Loss	521	578	—	—
Net Periodic Benefit Cost	\$ 1,963	\$ 1,889	\$ 23	\$ 19
Percent recognized by UNS Gas based on relative employee participation	51%	53%	45%	40%

The non-service components of net periodic benefit cost are included in Other, Net on the Statements of Income. Approximately 33% of the 2019 and 30% of the 2018 service cost was capitalized as a cost of construction.

The changes in plan assets and benefit obligations recognized as regulatory assets were as follows:

(in thousands)	Pension Benefits		Other Postretirement Benefits	
	2019	2018	2019	2018
	Current Year Actuarial (Gain) Loss	\$ 1,684	\$ (861)	\$ 48
Amortization of Net Loss	(521)	(578)	—	—
Amortization of Prior Service Credit	—	—	3	3
Total Recognized (Gain) Loss	\$ 1,163	\$ (1,439)	\$ 51	\$ (12)

UNS Gas amortizes prior service costs on a straight-line basis over the average remaining service period of employees expected to receive benefits under the plan.

Net periodic benefit cost is subject to various assumptions and determinations, such as the discount rate, the rate of compensation increase, and the expected return on plan assets. Changes that may arise over time with regard to these assumptions and determinations will change amounts recorded in the future as net periodic benefit cost.

UNS Gas uses a combination of sources in selecting the expected long-term rate-of-return-on-assets assumption, including an investment return model. The model used provides a “best-estimate” range over 20 years from the 25th percentile to the 75th percentile. The model, used as a guideline for selecting the overall rate-of-return-on-assets assumption, is based on forward-looking return expectations only. The above method is used for all asset classes.

The following table includes the weighted average assumptions used to determine benefit obligations:

	Pension Benefits		Other Postretirement Benefits	
	2019	2018	2019	2018
	Discount Rate	3.6%	4.5%	3.3%
Rate of Compensation Increase	2.8%	2.8%	N/A	N/A

The following table includes the weighted average assumptions used to determine net periodic benefit costs:

	Pension Benefits		Other Postretirement Benefits	
	2019	2018	2019	2018
	Discount Rate, Service Cost	4.6%	3.8%	4.5%
Discount Rate, Interest Cost	4.3%	3.6%	4.0%	3.2%
Rate of Compensation Increase	2.8%	2.8%	N/A	N/A
Expected Return on Plan Assets	7.0%	7.0%	N/A	N/A

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

Healthcare cost trend rates are assumed to decrease gradually from next year to the year the ultimate rate is reached:

	December 31,	
	2019	2018
Next Year (Pre-65)	6.3%	6.5%
Next Year (Post-65)	7.5%	7.8%
Ultimate Rate Assumed (Pre-65 and Post-65)	4.5%	4.5%
Year Ultimate Rate is Reached (Pre-65)	2037	2037
Year Ultimate Rate is Reached (Post-65)	2037	2037

PENSION PLAN ASSETS

UES calculates the fair value of plan assets on December 31, the measurement date. Pension plan asset allocations, by asset category, on the measurement date were as follows:

Asset Category	December 31,	
	2019	2018
Equity Securities	54%	54%
Fixed Income Securities	42%	42%
Real Estate	4%	4%
Total	100%	100%

The following tables present the fair value measurements of UES' pension plan assets by level within the fair value hierarchy:

Asset Category	Level 1	Level 2	Total
	December 31, 2019		
(in thousands)			
Cash Equivalents	\$ 32	\$ —	\$ 32
Equity Securities			
United States Large Cap	—	5,171	5,171
United States Small Cap	—	1,773	1,773
Non-United States	—	7,623	7,623
Global	—	4,612	4,612
Fixed Income	—	14,751	14,751
Real Estate	—	1,436	1,436
Total	\$ 32	\$ 35,366	\$ 35,398

Asset Category	December 31, 2018		
	Level 1	Level 2	Total
(in thousands)			
Cash Equivalents	\$ 26	\$ —	\$ 26
Equity Securities			
United States Large Cap	—	3,959	3,959
United States Small Cap	—	1,366	1,366
Non-United States	—	5,895	5,895
Global	—	3,564	3,564
Fixed Income	—	11,581	11,581
Real Estate	—	1,074	1,074
Total	\$ 26	\$ 27,439	\$ 27,465

- Level 1 cash equivalents are based on observable market prices and are comprised of the fair value of commercial paper, money market funds, and certificates of deposit.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

- Level 2 investments comprise amounts held in commingled equity funds, United States bond funds, and real estate funds. Valuations are based on active market quoted prices for assets held by each respective fund.

Pension Plan Investments

Investment Goals

Asset allocation is the principal method for achieving each pension plan’s investment objectives while maintaining appropriate levels of risk. UNS Gas considers the projected impact on benefit security of any proposed changes to the current asset allocation policy. The expected long-term returns and implications for pension plan sponsor funding are reviewed in selecting policies to ensure that current asset pools are projected to be adequate to meet the expected liabilities of the pension plan. UNS Gas expects to use asset allocation policies weighted most heavily to equity and fixed income funds, while maintaining some exposure to real estate and opportunistic funds. Within the fixed income allocation, long-duration funds may be used to partially hedge interest rate risk.

Risk Management

UNS Gas recognizes the difficulty of achieving investment objectives in light of the uncertainties and complexities of the investment markets. The Company recognizes some risk must be assumed to achieve a pension plan’s long-term investment objectives. In establishing risk tolerances, the following factors affecting risk tolerance and risk objectives will be considered: (i) plan status; (ii) plan sponsor financial status and profitability; (iii) plan features; and (iv) workforce characteristics. UNS Gas determined that the pension plan can tolerate some interim fluctuations in market value and rates of return in order to achieve long-term objectives. UNS Gas tracks the pension plan’s portfolio relative to the benchmark through quarterly investment reviews. The reviews consist of a performance and risk assessment of all investment categories and on the portfolio as a whole. Investment managers for the pension plan may use derivative financial instruments for risk management purposes or as part of their investment strategy. Currency hedges may also be used for defensive purposes.

Relationship between Plan Assets and Benefit Obligations

The overall health of the plan will be monitored by comparing the value of plan obligations (both Accumulated Benefit Obligation and Projected Benefit Obligation) against the fair value of assets and tracking the changes in each. The frequency of this monitoring will depend on the availability of plan data, but will be no less frequent than annually via actuarial valuation.

Target Allocation Percentages

The current target allocation percentages for the major asset categories of the plan follow. The plan allows a variance of +/- 2% from targets before funds are automatically rebalanced.

	December 31, 2019
Equity Securities:	
United States Large Cap	14%
United States Small Cap	5%
Global Equity	32%
Global Infrastructure	3%
Fixed Income	42%
Real Estate	4%
Total	100%

Pension Fund Descriptions

For each type of asset category selected by the Pension Committee, UNS Gas' investment consultant assembles a group of third-party fund managers and allocates a portion of the total investment to each fund manager.

ESTIMATED FUTURE BENEFIT PAYMENTS

UES expects the following benefit payments to be made by the plans, which reflect future service, as appropriate.

(in thousands)	2020	2021	2022	2023	2024	2025-2029
Pension Benefits	\$ 2,439	\$ 2,618	\$ 2,953	\$ 2,928	\$ 2,832	\$ 15,768
Other Postretirement Benefits	74	71	67	62	58	224

DEFINED CONTRIBUTION PLAN

UNS Gas offers a defined contribution savings plan to all eligible employees. The plan meets the IRS required standards for 401(k) qualified plans. Participants direct the investment of contributions to certain funds in their account. The Company matches part of a participant’s contributions to the plan. UNS Gas made matching contributions to the plan of \$0.3 million in 2019 and 2018.

NOTE 11. SUPPLEMENTAL CASH FLOW INFORMATION

CASH TRANSACTIONS

(in thousands)	Years Ended December 31,	
	2019	2018
Interest Paid, Net of Amounts Capitalized	\$ 4,541	\$ 4,539
Income Taxes Paid	—	1,500

NON-CASH TRANSACTIONS

Other significant non-cash investing and financing activities that resulted in recognition of assets and liabilities but did not result in cash receipts or payments were as follows:

(in thousands)	Years Ended December 31,	
	2019	2018
Operating Leases ⁽¹⁾	\$ 3,225	\$ —
Net Cost of Removal ⁽²⁾	1,306	1,526
Accrued Capital Expenditures	1,015	1,234

⁽¹⁾ On January 1, 2019, UNS Gas adopted accounting guidance that requires lessees to recognize a lease liability and a right-of-use asset for all leases with a lease term greater than 12 months. UNS Gas applied the transition provisions of the new standard as of the adoption date and did not retrospectively adjust prior periods.

⁽²⁾ Represents an accrual for future cost of retirement net of salvage values that does not impact earnings.

NOTE 12. FAIR VALUE MEASUREMENTS AND DERIVATIVE INSTRUMENTS

UNS Gas categorizes financial instruments into the three-level hierarchy based on inputs used to determine the fair value. Level 1 inputs are unadjusted quoted prices for identical assets or liabilities in an active market. Level 2 inputs include quoted prices for similar assets or liabilities, quoted prices in non-active markets, and pricing models whose inputs are observable, directly or indirectly. Level 3 inputs are unobservable and supported by little or no market activity. UNS Gas has no financial instruments categorized as Level 3.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A RECURRING BASIS

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

(in thousands)	Level 1	Level 2	Total
	December 31, 2019		
Assets			
Cash Equivalents ⁽¹⁾	\$ 2,000	\$ —	\$ 2,000
Energy Derivative Contracts, Regulatory Recovery ⁽²⁾	—	1,297	1,297
Energy Derivative Contracts, No Regulatory Recovery ⁽²⁾	—	448	448
Total Assets	2,000	1,745	3,745
Liabilities			
Energy Derivative Contracts, Regulatory Recovery ⁽²⁾	—	(3,694)	(3,694)
Energy Derivative Contracts, No Regulatory Recovery ⁽²⁾	—	(184)	(184)
Total Liabilities	—	(3,878)	(3,878)
Total Assets (Liabilities), Net	\$ 2,000	\$ (2,133)	\$ (133)
(in thousands)	December 31, 2018		
Assets			
Cash Equivalents ⁽¹⁾	\$ 6,000	\$ —	\$ 6,000
Energy Derivative Contracts, Regulatory Recovery ⁽²⁾	—	1,326	1,326
Energy Derivative Contracts, No Regulatory Recovery ⁽²⁾	—	318	318
Total Assets	6,000	1,644	7,644
Liabilities			
Energy Derivative Contracts, Regulatory Recovery ⁽²⁾	—	(4,391)	(4,391)
Energy Derivative Contracts, No Regulatory Recovery ⁽²⁾	—	(275)	(275)
Total Liabilities	—	(4,666)	(4,666)
Total Assets (Liabilities), Net	\$ 6,000	\$ (3,022)	\$ 2,978

⁽¹⁾ Cash Equivalents represent amounts held in money market funds valued at cost, including interest, which approximates fair market value. Cash Equivalents are included in Cash and Cash Equivalents on the Balance Sheets.

⁽²⁾ Energy Derivative Contracts include gas swap agreements (Level 2) entered into to reduce exposure to energy price risk, and certain customer supply contracts (Level 2). These contracts are included in Derivative Instruments on the Balance Sheets.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

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

	Gross Amount Recognized in the Balance Sheets	Gross Amount Not Offset in the Balance Sheets		Net Amount
		Counterparty Netting of Energy Contracts	Cash Collateral Received/Posted	
(in thousands)				
December 31, 2019				
Derivative Assets				
Energy Derivative Contracts	\$ 1,745	\$ 1,300	\$ —	\$ 445
Derivative Liabilities				
Energy Derivative Contracts	(3,878)	(1,300)	—	(2,578)
(in thousands)				
December 31, 2018				
Derivative Assets				
Energy Derivative Contracts	\$ 1,644	\$ 1,394	\$ —	\$ 250
Derivative Liabilities				
Energy Derivative Contracts	(4,666)	(1,394)	—	(3,272)

DERIVATIVE INSTRUMENTS

UNS Gas enters into various derivative and non-derivative contracts to reduce exposure to energy price risk associated with its natural gas purchase requirements. The objectives for entering into such contracts include: (i) creating price stability; (ii) meeting load and reserve requirements; and (iii) reducing exposure to price volatility that may result from delayed recovery under the PGA mechanism.

The Company primarily applies the market approach for recurring fair value measurements. When UNS Gas has observable inputs for substantially the full term of the asset or liability or uses quoted prices in an inactive market, it categorizes the instrument in Level 2. UNS Gas categorizes derivatives in Level 3 when an aggregate pricing service or published prices that represent a consensus reporting of multiple brokers is used.

For natural gas prices, UNS Gas obtains quotes from brokers, major market participants, exchanges, or industry publications and relies on its own price experience from active transactions in the market. The Company primarily uses one set of quotations and then validates those prices using other sources. UNS Gas believes that the market information provided is reflective of market conditions as of the time and date indicated.

UNS Gas also considers the impact of counterparty credit risk using current and historical default and recovery rates, as well as its own credit risk using credit default swap data.

The inputs and the Company's assessments of the significance of a particular input to the fair value measurements require judgment and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels. UNS Gas reviews the assumptions underlying its price curves monthly.

Energy Derivative Contracts, Regulatory Recovery

UNS Gas enters into energy contracts that are considered derivatives and qualify for regulatory recovery. The realized gains and losses on these energy contracts are recovered through the PGA mechanism and the unrealized gains and losses are deferred as a regulatory asset or a regulatory liability. The table below presents the unrealized gains and losses recorded to a regulatory asset or a regulatory liability on the balance sheet:

	Years Ended December 31,	
	2019	2018
(in thousands)		
Unrealized Net Gain	\$ 670	\$ 2,741

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)

Derivative Volumes

As of December 31, 2019, UNS Gas had energy contracts that will settle on various expiration dates through 2023. The following table presents volumes associated with the energy contracts:

	December 31,	
	2019	2018
Gas Contracts BBTu	18,065	15,142

CREDIT RISK

The use of contractual arrangements to manage the risks associated with changes in energy commodity prices creates credit risk exposure resulting from the possibility of non-performance by counterparties pursuant to the terms of their contractual obligations. UNS Gas enters into contracts for the physical delivery of natural gas which contain remedies in the event of non-performance by the supply counterparties. In addition, volatile natural gas prices can create significant credit exposure from natural gas market receivables and subsequent measurements at fair value.

UNS Gas has contractual agreements for energy procurement and hedging activities that contain certain provisions requiring UNS Gas and its counterparties to post collateral under certain circumstances. These circumstances include: (i) exposures in excess of unsecured credit limits; (ii) credit rating downgrades; or (iii) a failure to meet certain financial ratios. In the event that such credit events were to occur, the Company, or its counterparties, would have to provide certain credit enhancements in the form of cash, LOCs, or other acceptable security to collateralize exposure beyond the allowed amounts.

UNS Gas considers the effect of counterparty credit risk in determining the fair value of derivative instruments that are in a net asset position, after incorporating collateral posted by counterparties, and then allocates the credit risk adjustment to individual contracts. The Company also considers the impact of its credit risk on instruments that are in a net liability position, after considering the collateral posted, and then allocates the credit risk adjustment to the individual contracts.

The value of all derivative instruments in net liability positions under contracts with credit risk-related contingent features, including contracts under the normal purchase normal sale exception, was \$8.6 million as of December 31, 2019, compared with \$10.4 million as of December 31, 2018. As of December 31, 2019, UNS Gas had no collateral posted with its counterparties. If the credit risk contingent features were triggered on December 31, 2019, UNS Gas would have been required to post an additional \$8.6 million of collateral of which \$5.7 million relates to outstanding net payable balances for settled positions.

FINANCIAL INSTRUMENTS NOT CARRIED AT FAIR VALUE

The fair value of a financial instrument is the market price to sell an asset or transfer a liability at the measurement date. Borrowings under revolving credit facilities approximate fair value due to the short-term nature of these financial instruments. These items have been excluded from the table below.

The use of different estimation methods and/or market assumptions may yield different estimated fair value amounts. The following table includes the net carrying value and estimated fair value of UNS Gas' long-term debt:

(in thousands)	Fair Value Hierarchy	Net Carrying Value		Fair Value	
		December 31,			
		2019	2018	2019	2018
Liabilities					
Long-Term Debt, including Current Maturities	Level 2	\$ 94,444	\$ 94,403	\$ 108,723	\$ 98,639

NOTE 13. INCOME TAXES

Income Tax Expense included on the Statements of Income consists of the following:

(in thousands)	Years Ended December 31,	
	2019	2018
Current Income Tax Expense		
Federal	\$ 2,130	\$ 1,662
State	290	192
Total Current Income Tax Expense	2,420	1,854
Deferred Income Tax Expense		
Federal	1,247	905
State	561	431
Total Deferred Income Tax Expense	1,808	1,336
Total Federal and State Income Tax Expense	\$ 4,228	\$ 3,190

On December 22, 2017, the President of the United States of America signed into law the TCJA, which enacted significant changes to the Internal Revenue Code, including a reduction in the federal corporate income tax rate from 35% to 21% effective for tax years beginning after 2017.

The significant components of deferred income tax assets and liabilities consist of the following:

(in thousands)	December 31,	
	2019	2018
Gross Deferred Income Tax Assets		
Customer Advances	\$ 1,184	\$ 1,209
Contributions in Aid of Construction	4,179	3,844
Compensation and Benefits	429	425
Fortis Acquisition Customer Credits	—	51
Income Taxes Recoverable Through Future Rates	7,172	7,350
Other	769	111
Total Gross Deferred Income Tax Assets	13,733	12,990
Gross Deferred Income Tax Liabilities		
Plant, Net	(44,798)	(42,616)
Income Taxes Payable Through Future Rates	(630)	(730)
Other	(984)	(204)
Total Gross Deferred Income Tax Liabilities	(46,412)	(43,550)
Deferred Income Taxes, Net	\$ (32,679)	\$ (30,560)

UNS Gas recorded no valuation allowance against deferred income tax assets as of December 31, 2019 and 2018. Management believes that based on the historical pattern of taxable income, UNS Gas will produce sufficient taxable income in the future to realize its deferred tax assets.

Included in Accounts Receivable, Net and Accounts Payable are current income taxes receivable and payable that are due from and to affiliates, respectively. UNS Gas' net intercompany income taxes were a receivable of \$0.5 million and a payable of \$0.5 million as of December 31, 2019 and 2018, respectively.

UNS Gas recorded no interest expense in 2019 and 2018. In addition, UNS Gas had no interest payable and no penalties accrued as of December 31, 2019 and 2018.

UNS Gas has been audited by the IRS through tax year 2010. The Company's 2011 to 2018 tax years are open for audit by federal and state tax agencies.