PALO VERDE NUCLEAR GENERATING STATION

LICENSE APPLICATION

ARIZONA PUBLIC SERVICE COMPANY
PROJECT MANAGER AND OPERATING AGENT

CONTENTS

LICENSE APPLICATION

GENERAL INFORMATION REQUIRED BY SECTION 50.33 AND APPENDIX C OF 10 CFR PART 50

ARIZONA PUBLIC SERVICE COMPANY
P. O. BOX 21666 · PHOENIX, ARIZONA 85036

October 1, 1979
ANPP-13904 - JMA/DBK

Director of Nuclear Reactor Regulation
U.S. Nuclear Regulatory Commission
Washington, D.C. 20555

Re: Joint Application for Operating
Licenses for Palo Verde Nuclear
Generating Station Units 1, 2 and 3
NRC Docket Nos. STN 50-528/529/530

References: Letter, ANPP-13905, dated September 28, 1979
to Harold R. Denton, Director, Office of
Nuclear Reactor Regulation, NRC from
E. E. Van Brunt, Jr., Vice President, APS

Dear Sir:

Pursuant to 10 CFR Part 50, Arizona Public Service Company (APS) submits herewith this joint application for the issuance of operating licenses under Sections 103 and 185 of the Atomic Energy Act of 1954, as amended, for utilization facilities known as the Palo Verde Nuclear Generating Station Units 1, 2 and 3.

Palo Verde Nuclear Generating Station (PVNGS) is the name which has been given to a site situated in Maricopa County, Arizona, approximately 36 miles west of the western boundary of the City of Phoenix, at which Palo Verde Units 1, 2 and 3 are currently under construction, pursuant to Construction Permits Nos. CPPR 141, CPPR 142 and CPPR 143, respectively, issued in Docket Nos. STN 50-528, STN 50-529 and STN 50-530, respectively.

Palo Verde Nuclear Generating Station, including each of Palo Verde Units 1, 2 and 3, is currently jointly owned by the joint-applicants listed below, sometimes referred to as "Participants," as tenants in common with undivided ownership interests in the respective percentages hereinafter set forth, all in accordance with the Arizona Nuclear Power Project Participation Agreement, dated as of August 23, 1973, as amended by Amendment Nos. 1 through 4 (hereinafter, as so amended, referred to as the "Participation Agreement").

Joint Applicants		Undivided Interest
Arizona Public Service Company	(APS)	29.1%
Salt River Project Agricultural Improvement and Power District	(SRP)	29.1%
Southern California Edison Company	(SCE)	15.8%
El Paso Electric Company	(EPE)	15.8%
Public Service Company of New Mexico	(PSNM)	10.2%

However, pursuant to an agreement dated August 18, 1977, between SRP and the Department of Water and Power of the City of Los Angeles (LADWP), SRP will transfer to LADWP, and LADWP will acquire from SRP, a 5.7% undivided ownership interest as a tenant in common with the other Participants in the Palo Verde Nuclear Generating Station, including each of Palo Verde Units 1, 2 and 3, at such time as Palo Verde Unit 1 is placed into commercial operation (i.e., when it is deemed to be available as a reliable source of electric generation).

Pursuant to the Participation Agreement (a copy of which is included as Appendix 1A to Section 1 of the General Information submitted herewith pursuant to 10 CFR Part 50.33), APS has been designated as the Project Manager and Operating Agent of Palo Verde Units 1, 2 and 3, and in such capacities is responsible for the engineering, design, construction, quality assurance, operation, and maintenance of such units and is authorized to submit and prosecute on its own behalf and the behalf of all the joint applicants all applications for any permits, licenses, authorizations, and approvals requisite to the engineering, design, construction, quality assurance, operation, and maintenance of such units.

Accordingly, this joint application seeks the issuance of construction permits and operating licenses authorizing APS to construct, operate and maintain Palo Verde Units 1, 2 and 3 on its own behalf and as agent for all other joint applicants and authorizing all joint applicants to acquire and own undivided interests in each of said units as tenants in common in the percentages hereinabove set forth. Additionally, this joint application further seeks approval of the transfer by SRP to LADWP, and the acquisition by LADWP from SRP, of a 5.7% undivided ownership interest as a tenant in common in the Palo Verde Nuclear Generating Station, including each of Palo Verde Units 1, 2 and 3, as and when such transfer and acquisition shall become effective as hereinabove set forth.

In support and as a part of this joint application, APS submits the General Information required by Section 50.33 and Appendix C of 10 CFR Part 50 and the following parts:

Part 1: Antitrust Information Required by Regulatory Guide 9.3.

Part 2: Palo Verde Nuclear Generating Station Units 1, 2 and 3. Final Safety Analysis Report (FSAR).

The Palo Verde Nuclear Generating Station Units 1, 2 and 3 Environmental Report - Operating License Stage (ER-OL) will be submitted within six (6) months as permitted by 10 CFR Section 2.101 (a) (5).

Consistent with the Commission's announced policy encouraging standardization of nuclear power plants, it is intended that the Palo Verde Units 1, 2 and 3 shall be identical in all respects and each unit will utilize the Combustion Engineering, Inc. (C-E) standard "System 80" nuclear steam supply system. Moreover, to further permit the accelerated review of this joint application, the FSAR, pursuant to the Commission's policy statement of March 5, 1973, and Appendix O of 10 CFR Part 50, follows the "Reference System" concept and incorporates by reference the C-E Final Standard Safety Analysis Report (CESSAR-F) currently under review by the Commission in NRC Docket No. STN-50-470. The manner in which CESSAR-F is incorporated is explained in Section 1.9 of the FSAR.

By Reference (1), a report was submitted to the Director, Office of Nuclear Reactor Regulation responsive to the requirements of the first report of the TMI-2 Lessons Learned Task Force (NUREG-0578) as modified pursuant to the memorandum, dated August 20, 1979, from Harold R. Denton, Director, Office of Nuclear Reactor Regulation to the NRC Commissioners. The report submitted with Reference (1) evaluates the applicability of the several requirements of NUREG to Palo Verde Units 1, 2 and 3 and includes the commitments of APS to meet such requirements within the time schedule established by NUREG-0578. As designs, analyses and other information are developed to carry out such commitments, the FSAR will be amended accordingly.

It is vital to the interests of the joint applicants and the public served by them that Palo Verde Unit 1 be available for commercial operation not later than May 1, 1983. In order to meet this scheduled date in an orderly and efficient manner, we plan to complete construction of and to commence the loading of fuel into Palo Verde Unit 1 on or about November 1, 1982. Since such fuel loading cannot proceed without an operating license as required by law, it is requested that the Commission's review of this joint application be scheduled and conducted in a manner that, with an appropriate allowance for any contested hearing as may be required or permitted by law and any stays of decisions resulting therefrom, will permit the issuance of an operating license for Palo Verde Unit 1 on or before November 1, 1982.

Mr. Edwin E. Van Brunt, Jr., Vice President, Arizona Public Service Company, has been delegated the authority and responsibility to administer this joint application. Accordingly, please address all communications in respect thereof to Mr. Van Brunt at the following address:

Mr. E. E. Van Brunt, Jr.
Vice President
Arizona Public Service Company
P. O. Box 21666
Phoenix, Arizona 85036

with a copy thereof to our attorney in this matter:

Arthur C. Gehr, Esq.
Snell & Wilmer
3100 Valley Center
Phoenix, Arizona 85073

Respectfully submitted,

ARIZONA PUBLIC SERVICE COMPANY

By: Edwin E. Van Brunt
Edwin E. Van Brunt, Jr.
Vice President

On its own behalf and as agent for
all other joint participants

STATE OF ARIZONA)
) ss.
County of Maricopa)

Subscribed and sworn to before me this 26 day of Sept, 1979.

John M Allen
Notary Public

My Commission expires:
My Commission Expires Jan. 23, 1983

GENERAL INFORMATION REQUIRED BY SECTION 50.33 AND APPENDIX C OF 10 CFR PART 50

CONTENTS

SECTION 1

GENERAL INFORMATION RESPECTING JOINT APPLICANT ARIZONA PUBLIC SERVICE COMPANY

(a) Name of joint applicant:

Arizona Public Service Company

(b) Address of joint applicant

411 North Central Avenue
Post Office Box 21666
Phoenix, Arizona 85036

(c) Description of the business of joint applicant:

Pursuant to its Articles of Incorporation and certificates of public convenience and necessity issued by the Arizona Corporation Commission in accordance with the laws of the State of Arizona, Arizona Public Service Company is engaged in the business of generating, transmitting, and distributing electricity and distributing gas to the public in and surrounding 241 communities in its service territory comprising approximately 50,000 square miles in 11 of the 14 counties in the State of Arizona.

(d) (1) Not applicable.

(d) (2) Not applicable.

(d) (3) (i) State of incorporation and principal location:

Arizona Public Service Company is a corporation organized and existing under and by virtue of the laws of the State of Arizona. Its general offices are located at 411 North Central Avenue, Phoenix, Arizona.

(d) (3) (ii) Names, addresses, and citizenship of directors and principal officers.

Directors of Arizona Public Service Company

Name	Address
Ralph M. Bilby	Chairman of the Board Arizona Public Service Company P. O. Box 21666 Phoenix, Arizona 85036
Karl Eller	President Combined Communications Corporation P.O. Box 25518 Phoenix, Arizona 85002
Del W. Fisher	Chairman of the Board Fisher Contracting Company P. O. Box 6537 Phoenix, Arizona 85005
William T. Garland	Chairman of the Board Garland-Rhuart Development Corporation P. O. Box 851 Sedona, Arizona 86336
Leon Levy	Honorary Chairman of the Board First National Bank of Arizona P. O. Box 1871 Tucson, Arizona 85702
Victor H. Lytle	P. O. Box 870 Prescott, Arizona 86301
Marvin R. Morrison	Morrison Brothers Ranch Route 1, Box 13 Highley, Arizona 85236
Henry B. Sargent, Jr.	Vice President Arizona Public Service Company P. O. Box 21666 Phoenix, Arizona 85036
Wilma W. Schwada	2400 South College Avenue Tempe, Arizona 85282
Richard Snell	Snell & Wilmer 3100 Valley Center Phoenix, Arizona 85073

Name	Address
Donald N. Soldwedel	Publisher and General Manager Yuma Daily Sun P. O. Box 271 Yuma, Arizona 85364
Maurice R. Tanner	Chairman of the Board, President and Chief Executive Officer The Tanner Companies P. O. Box 20128 Phoenix, Arizona 85036
Keith L. Turley	President and Chief Executive Officer Arizona Public Service Company 411 North Central Avenue P. O. Box 21666 Phoenix, Arizona 85036
Douglas J. Wall	Mangum, Wall, Stopps & Warden P. O. Box 10 Flagstaff, Arizona 86001
Morrison F. Warren	1061 E. Magdelena Drive Tempe, Arizona 85283
K. O. Wilbanks	President First National Bank of Farmington P. O. Box 540 Farmington, New Mexico 87401
Ben F. Williams, Jr.	P. O. Drawer W Douglas, Arizona 85607
Thomas G. Woods, Jr.	Executive Vice President Arizona Public Service Company P. O. Box 21666 Phoenix, Arizona 85036

Principal Officers of Arizona Public Service Company

Ralph M. Bilby	Chairman of the Board
Karl Eller	Chariman of the Executive Committee
Keith L. Turley	President and Chief Executive Officer

Thomas G. Woods, Jr.	Executive Vice President, Operations
D. L. Broussard	Vice President, Research and Development
O. M. De Michele	Vice President, Corporate Relations
Howard F. Hersey	Vice President, Gas Operations
Russell D. Hulse	Vice President, Resources Planning
Jerry P. Human	Vice President, Customer Services
Charles D. Jarman	Vice President, Engineering and Construction
Lyman K. Mundth	Vice President, Electric Operations
Henry B. Sargent, Jr.	Financial Vice President
Edwin E. Van Brunt, Jr.	Vice President, Nuclear Projects Management
George H. Toler	Treasurer
William T. Quinsler	Secretary and Assistant Treasurer
Gerald J. Griffin	Assistant Secretary

The address of all of the foregoing principal officers of Arizona Public Service Company (except Ralph M. Bilby and Karl Eller, whose addresses are given in the list of directors) is:

411 North Central Avenue
Post Office Box 21666
Phoenix, Arizona 85036

Each of the directors and principal officers of Arizona Public Service Company is a citizen of the United States of America.

(d) (3) (iii) Arizona Public Service Company is not owned, controlled, or dominated by an alien, a foreign corporation, or a foreign government.

(d) (4) As set forth in the joint application, joint applicant Arizona Public Service Company is acting for itself and as agent for the other joint applicants herein. The information required under Paragraph (d) of Section 50.33, 10CFR Part 50, with respect to such other joint applicants is hereinafter set forth in Sections 2 to 5, inclusive. The authority and responsibility of joint applicant Arizona Public Service Company to act for itself and as agent for the joint applicants is set forth in the Arizona Nuclear Power Project Participation Agreement. A copy of said Participation Agreement is attached as Appendix 1B.

(e) (i) The joint application is for Class 103 licenses for PVNGS Units 1, 2 and 3.

(e) (ii) PVNGS Units 1, 2 and 3 will be used to generate electric power required to meet the demands for electric power of the public served by and to satisfy the reserve requirements of the joint applicants.

(e) (iii) Each of the Class 103 licenses for PVNGS Units 1, 2 and 3 is sought for a period of forty (40) years.

(3) (iv) The other licenses requested include only those authorizing the possession and use of source, special nuclear and by-product materials that are incidental to the startup and operation of PVNGS Units 1, 2 and 3.

(f) In accordance with 10CRF50, Appendix C, a copy of joint applicant Arizona Public Service Company's 1978 Financial Report is attached hereto as Appendix 1A.

(g) (Not used)

(h) Not applicable.

(i) The following listed regulatory agencies have jurisdiction over the rates and services of joint applicant Arizona Public Service Company:

Arizona Corporation Commission
Capitol Annex
Phoenix, Arizona 85007

Federal Energy Regulatory Commission
Washington, D.C. 20426

News publications that circulate in the area in which the facility will be located are:

The Arizona Republic
120 East Van Buren
Phoenix, Arizona 85004

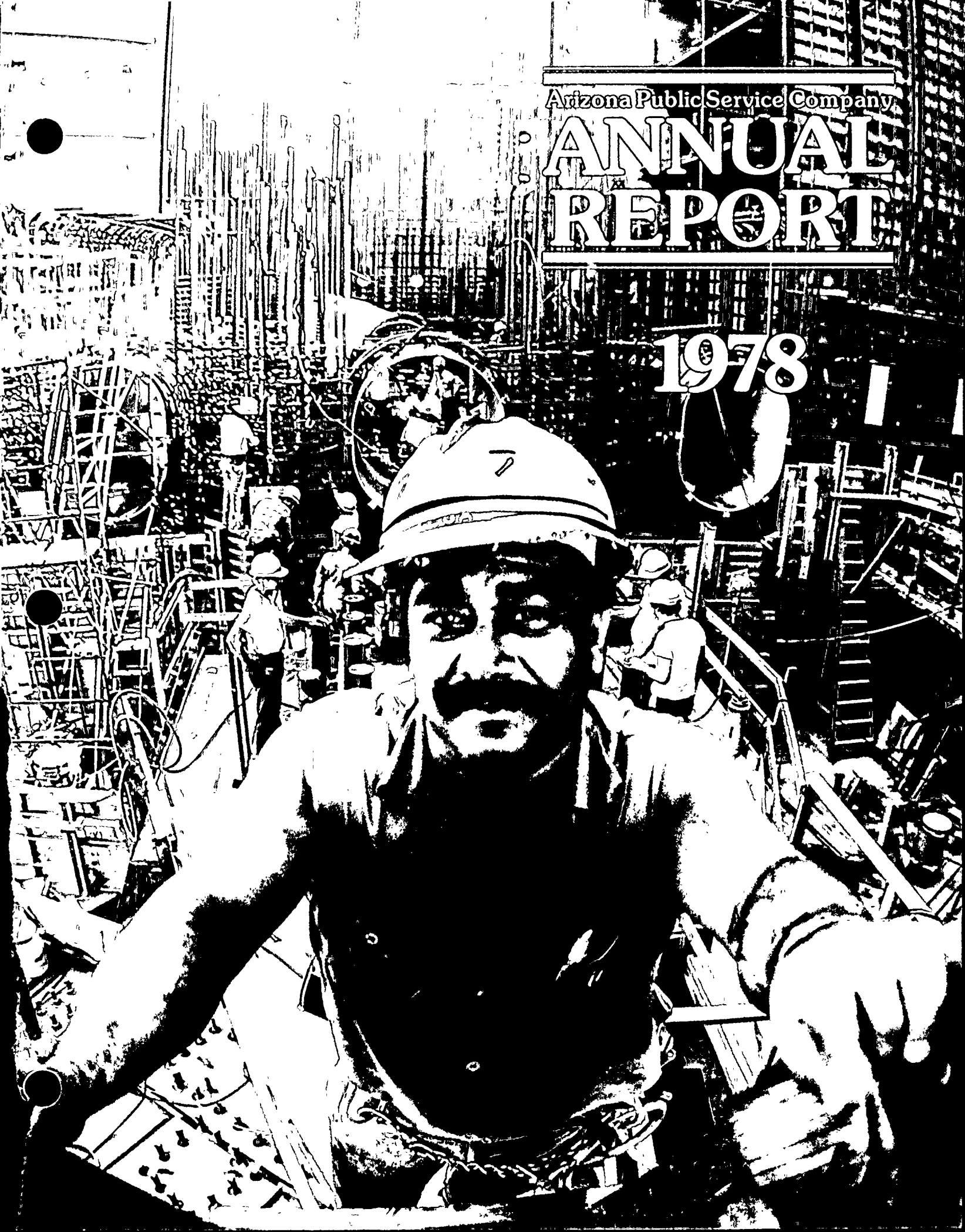
The Phoenix Gazette
120 East Van Buren
Phoenix, Arizona 85004

Buckeye Valley News
P. O. Box 217
Buckeye, Arizona 85326

(j) Not applicable.

APPENDIX 1A

ARIZONA PUBLIC SERVICE COMPANY 1978 ANNUAL REPORT



Arizona Public Service Company

ANNUAL REPORT

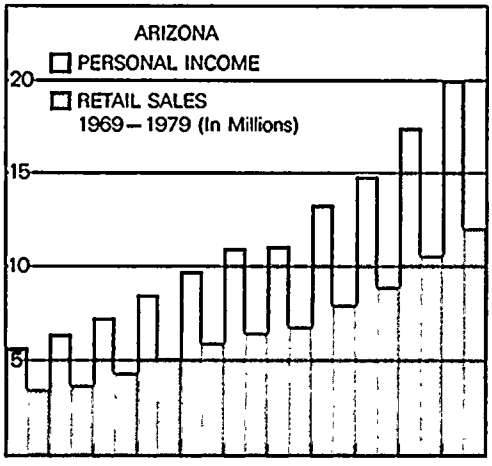
1978

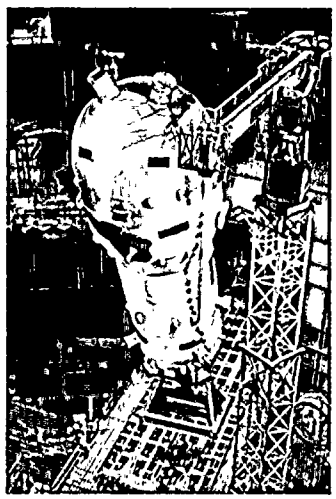
Highlights 1978

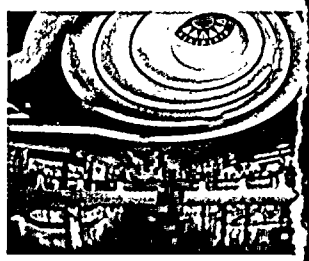
	1978	1977	% Increase (Decrease)
Property and Plant:			
Total utility plant, year end	$2,288,605,000	$1,889,320,000	21.1
Capital expenditures	$ 405,789,000	$ 311,773,000	30.2
Sales and Customers:			
Total operating revenues	$ 562,217,000	$ 493,684,000	13.9
Total electric sales (mwh)	10,912,704	10,481,972	4.1
Electric customers, year end	378,553	357,884	5.8
Total gas sales (m therms)	449,451	463,643	(3.1)
Gas customers, year end	339,803	339,949	—
Income, Earnings, Dividends:			
Net income	$ 106,759,000	$ 84,011,000	27.1
Earnings for common stock	$ 89,288,000	$ 69,383,000	28.7
Average common shares outstanding	28,363,223	22,970,741	23.5
Earnings (based on average shares outstanding)	$ 3.15	$ 3.02	4.3
Dividends paid per share of common stock	$ 1.73	$ 1.53	13.1
Shareholders:			
Common	78,275	66,358	18.0
Preferred	7,158	7,232	(1.0)
Employees, year end:	4,951	4,570	8.3

Annual Report
This report is published to provide general information concerning the company and not in connection with any sale, offer for sale, or solicitation of an offer to buy, any securities.

Annual Meeting of Stockholders
All stockholders are invited to attend the company's fifty-ninth annual meeting. It will be held at 10 a.m. Thursday, April 19, in the Grand Ballroom of the Adams Hotel, Central Avenue at Adams, Phoenix, Arizona.







Meeting the challenges of tomorrow

Our financial health...

We met the challenge to maintain an improved earnings and dividend picture despite a hefty construction budget . . Page 5.

Our vital growth...

We added 20,669 electric customers; began adding new natural gas customers; saw new coal and nuclear-fueled generating units continue to rise on Arizona's horizon. . Page 8.

Our concern for today...

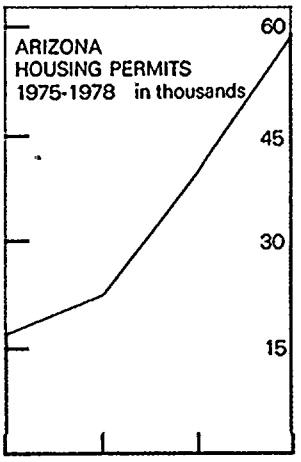
We saw increased public understanding and more effective customer participation become hallmarks of a marketing program aimed at trimming peak power demands; we've continued development of the most economical fuel mix for power generation, and have sustained our efforts to protect our unique southwestern environment ..... Page 10.

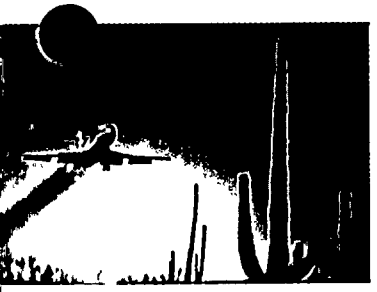
Our search for tomorrow...

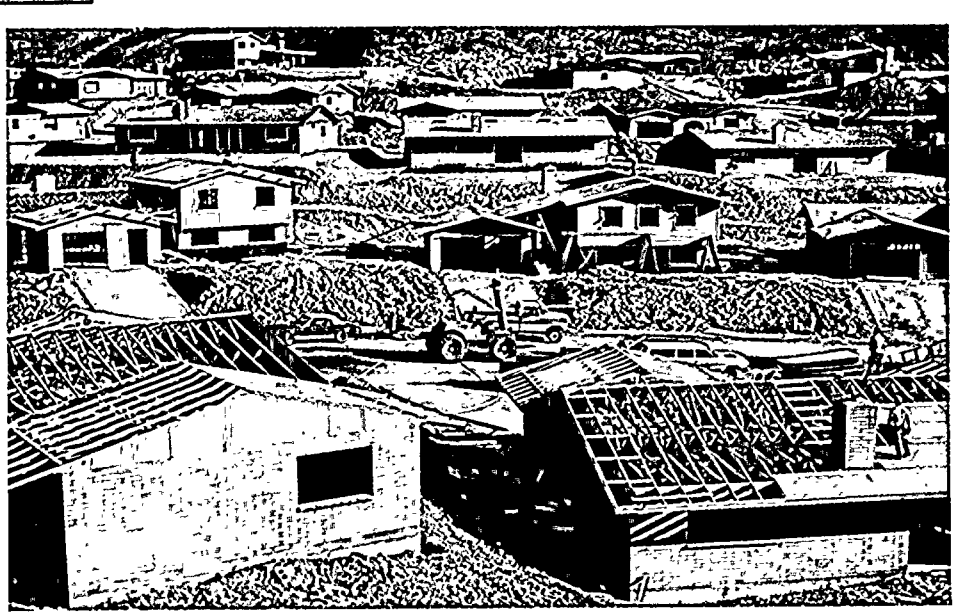
We continued our search for new sources of fuel to meet our customers' needs for economical energy, and expanded our research in new energy technologies for Arizona's tomorrow ..... Page 13.

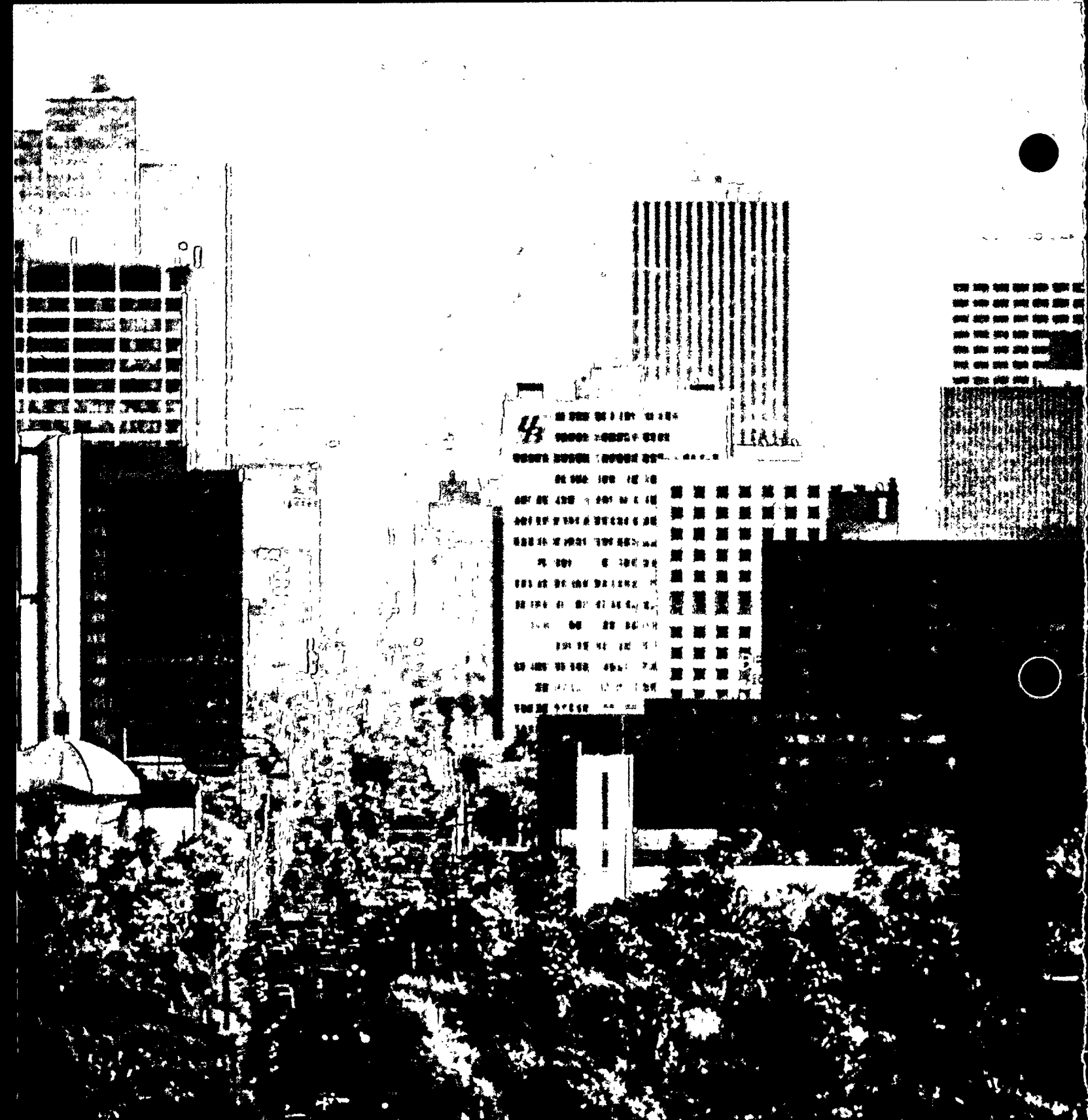
Our continuing dialogue...

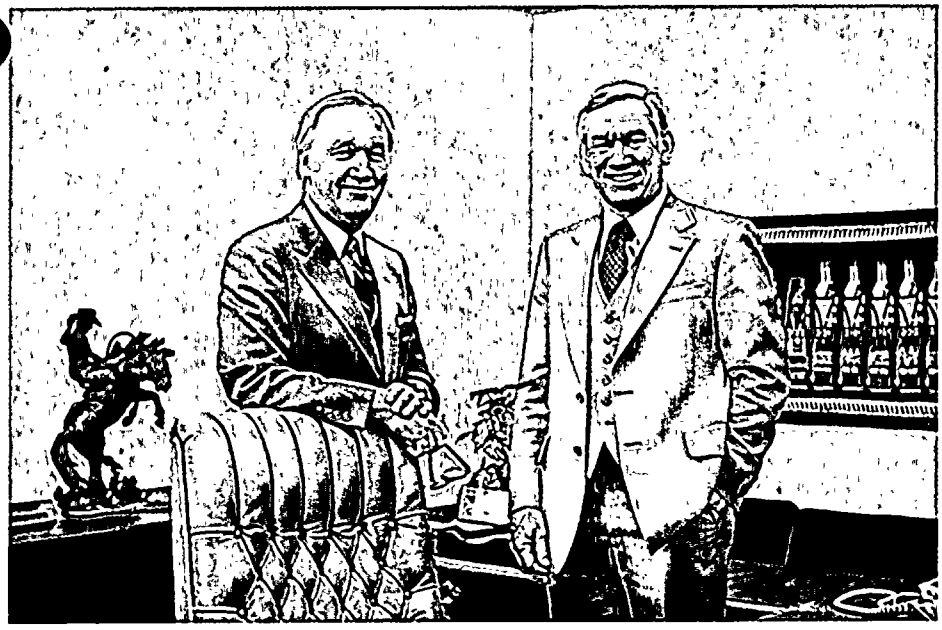
We launched new and improved communication and education programs to keep customers, employees and investors better informed about the Arizona energy scene, about our plans for tomorrow and the challenges we will face ..... Page 15.











Ralph M. Bilby (left), Chairman of the Board; Keith L. Turley, President and Chief Executive Officer.

To our Shareholders

This long lens compression of Phoenix' central corridor is not so much an exaggeration as a reflection of the extraordinary and continuing growth we have experienced in Arizona through the last three decades. Throughout our service territory there is evidence to confirm predictions that Arizona's population, which now totals about 2.5 million, will top the four million mark by the turn of the century.

In 1978, we successfully met many of the major challanges created by the area's dynamic growth. Our earnings reflected those successes, reaching a record $3.15 per share, up 13 cents over the previous high of $3.02 we reported in 1977. Dividends paid per share during 1978 totaled $1.73, an increase of 20 cents per share over 1977 totals. With your board's decision last fall to raise quarterly dividends from 42 cents per share to 47 cents, our indicated annual dividend is now $1.88.

We are encouraged by these figures as we continue our efforts to maintain and improve our financial health. Yet numbers alone fall far short of telling the whole story of Arizona Public Service Company's accomplishments in 1978. As the state's largest energy utility, we are planning, managing and building for the future . . . a future that will require even more reliable, economic energy supplies for a growing Arizona.

For today . . . and tomorrow

In this report, you'll read about our growth. About concrete and steel rising from the desert floor at the Palo Verde Nuclear Generating Station; about construction progress at the Cholla Power Plant in northeastern Arizona. You'll also read about efforts to assure future gas supplies for our customers whose numbers will increase with the lifting of a natural gas moratorium. In addition, you'll learn about the company's program to generate most of our electricity from economical coal and nuclear fuel.

Also highlighted is the company's continuing commitment to research in solar energy and other future energy sources. You'll find details about APS' efforts to locate, here in Arizona, the world's largest solar photovoltaic power plant.

. . . aware of our responsibilities

We see our role as more than that of energy supplier. APS has a unique opportunity to help shape Arizona's future — to address a whole series of interdependent issues that stem from the state's rapid growth. Our management objectives recognize these challenges. They will be met with the interests of stockholders, customers and all Arizonans in mind. In light of these objectives, it is our policy to speak out on local, state and national issues which can affect these interests and our future.

If we are to gain understanding and support for the programs vital to our company's future, we must recognize the importance of strengthening and improving information channels between the company and Arizona leaders. We must also recognize our responsibility to contribute to the development of future leaders who have the vision and imagination to guide our state. Action has been taken on both these fronts.

. . . we are preparing

Our own employees mirror the characteristics of Arizona's population. Many have been with the company or lived in Arizona less than five years. Some of these new employees are part of the highly-trained work force already preparing to operate the Palo Verde Nuclear Generating Station. But special skills and education are not

limited to the company's nuclear operations.

All areas of the company are increasingly dependent on highly trained individuals. They're needed, for example, to help APS search for economical fuels, improve customer service through computer technology, upgrade power plant efficiency, analyze environmental data, spearhead research efforts. Our challenge is to attract competent people and develop all our employees, because their performance is integrally linked to the company's future. We must sharpen their skills and provide the incentives that will keep these valuable people at Arizona Public Service.

In January, 1979, we implemented a savings plan for salaried employees designed not only to meet these goals, but to establish a method for giving employees a stake in the company's earnings performance. The plan should strengthen employee interest in APS and provide incentives for employees to work toward goals which are mutually beneficial to them and to shareholders. Participation has been encouraging, with 36 percent of eligible employees joining the plan during its first month.

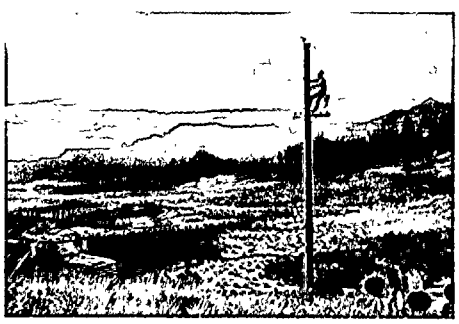
As a part of our continuing employee development effort, a concentrated management training program was initiated in 1978 in conjunction with Arizona State University. In addition, APS began a formalized development program aimed at providing employees the chance to acquire knowledge and skills necessary for advancement to managerial positions.

. . . for the challenges ahead

You, along with APS employees, have shown the support that helped us to successfully meet 1978's financial and operational objectives. Members of the executive team and the board of directors had the chance to outline our future plans and discuss the company's goals with many of you at the annual meeting and at additional shareholder meetings held in Tucson and Sun City.

But many challenges lie ahead, not the least of which will be raising the capital needed to build facilities to meet Arizona's growing energy needs. This difficult task, coupled with the increasing cost of doing business, fueled by our nation's high inflation rate and complicated by uncertainties created by federal price standards, will require even greater management effort in 1979.

These circumstances will severely test our ability to achieve the financial results we saw in 1978. Moreover, we can't overlook the fact that Arizona's past two summers were among the hottest in history. Thus, our customers used more electricity than normal and that use was reflected in better earnings than would have been achieved under cooler weather conditions.



In plain words, if we're going to maintain our financial stability and a healthy earnings picture, rate increases are absolutely necessary.

As you'll read in this report, APS increased electric rates by five percent on January 10, 1979 as provided in a previous Arizona Corporation Commission order. We will seek an additional increase, in hearings scheduled to begin May 16 before the commission. We will make every effort to stay within the guidelines issued by the President's Council on Wage and Price Stability as we seek these needed increases, provided we can do so without jeopardizing our financial health or impairing our ability to raise construction funds to meet the needs of a growing Arizona.

While growth provides feelings of anticipation, excitement and vitality, it also brings financial challenges we must meet. We will meet them with your continued support, with an enthusiastic, skilled group of employees and with public understanding.

Ralph M. Bilby
Chairman of the Board

Keith L. Turley
President and Chief Executive Officer

February 22, 1979

Our Financial Health

Our year-end earnings report reflects the success we've had at meeting the challenges of 1978.

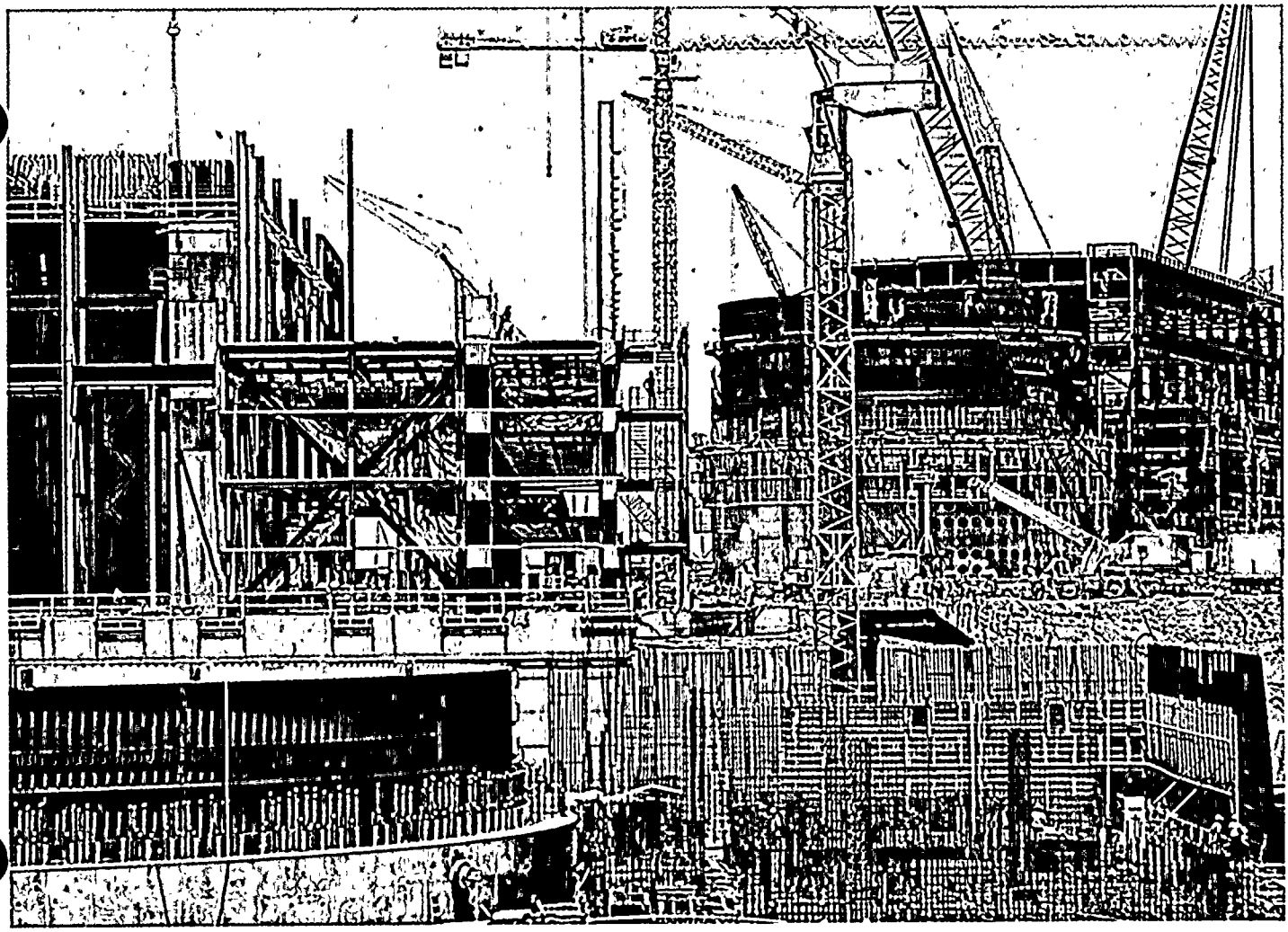
Earnings per share of common stock rose to $3.15, an increase of 13 cents per share over the previous high of $3.02 per share reported in 1977. A quarterly dividend increase from 42 cents per share of common stock to 47 cents, payable December 1 to shareholders of record November 6, brought total dividends per common share for the year to $1.73, up from $1.53 paid in 1977. The indicated annual dividend becomes $1.88.

The earnings improvement was due in part to the addition of more than 20,000 electric customers, reflecting the continuing vigorous growth of the area. Playing a major role in our financial health was the full effect of a 5.94 percent rate increase, put into effect on August 1, 1977, and an additional 5 percent electric rate increase effective January 10, 1978. The second hottest summer in Phoenix history also worked in favor of our earnings picture.

Planning, action, highlight efforts

But the improvement wasn't just a reflection of favorable circumstance. Our ability to maintain economic stability in the face of continued growth and soaring inflation is the result of extensive planning and aggressive action. We've pursued necessary rate increases in the face of rising concern over escalating consumer prices and we've gone to a highly-competitive capital market to find the millions of dollars needed for our vital construction program. A skillful employee team, with a blend of experience and youth, is working to find ways to squeeze more from every dollar spent.

We recognize the impact rising energy costs have had on our customers, and are continuing our efforts to balance customers' concerns with the needs of our share-



Palo Verde takes shape in steel and concrete. APS owns 29.1 percent of Units 1-2-3.

holders. This balance allows us to provide our customers with the energy they require, at the lowest possible cost.

Three-step sequence

Under terms of a three-stage rate order approved by the Arizona Corporation Commission in August, 1977, the company has implemented three separate "step" rate increases.

Step 1, effective in August, 1977, permitted an overall revenue increase of 5.94 percent; step 2, a five percent retail electric rate increase, was implemented in January, 1978; step 3, allowing an additional five percent electric rate increase, was put into effect on January 10, 1979. Final approval of the step 2 increase was received in December, 1978; a final decision on step 3 is expected from the commission later this year.

Part of the 1977 order required the company to submit detailed information to the commission, using 1978 as a test year, for a full-scale rate case later in 1979. Preliminary documents were filed in January indicating that an additional rate increase, above and beyond the five percent step 3 electric rate increase, will be needed. In question, however, is the extent to which federal price standards will influence our request.

By allowing the inclusion of certain amounts of construction work in progress in the rate base for the step one increase, and by approving the normalization of liberalized tax depreciation, the Arizona Corporation Commission demonstrated a forward-looking approach to the economic realities the company faces. The commission also allowed a 17.5 percent return on historical end-of-period common equity, thus recognizing the earnings attrition that takes place between the end of the historical "test period," and the time the company can actually collect the rates authorized by the commission.

Rate design improvements

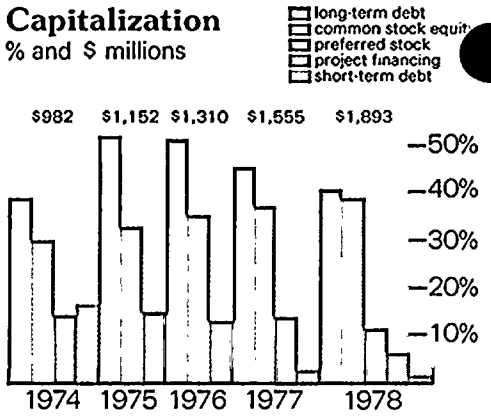
Major rate design improvements were also made in 1978 to better reflect the higher cost of producing electricity when customers' energy demands are highest. While eliminating regional differences in APS residential electric rates, the commission also approved a new rate design that tends to discourage wasteful use of electric energy.

APS is seeking additional residential rate design improvements that would help discourage energy waste and reduce peak loads. One of these proposals is for an energy capacity rate that would measure energy demand as well as consumption.

Extensive testing of these rates indicate that they offer customers financial incentives to trim peak energy demands, while taking into account the unique characteristics of Arizona's climate.

APS has also conducted time-of-use rate studies and examined other proposals advanced in recent national energy legislation. Many of these concepts have been discussed

Capitalization
% and $ millions

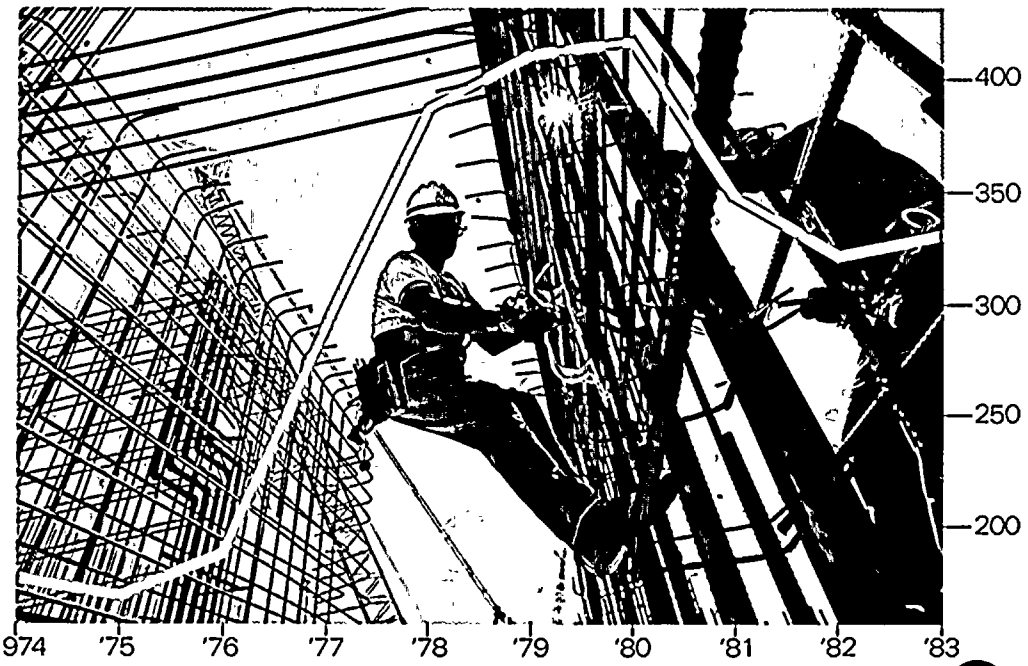


in past proceedings before the Arizona Corporation Commission and the company will continue its effort in this important area.

APS derived approximately 9.7 percent of electric operating revenues in 1978 from sales and charges regulated by the Federal Energy Regulatory Commission (FERC) and has various rate cases pending before that agency. The company anticipates resolution of these cases by FERC or settlement with the parties involved.

On December 29, 1978, a

Capital Expenditures millions of $



request was filed with FERC asking that a 13 percent increase in wholesale electric rates (in addition to our last proposed rates) be put into effect later in 1979. Previously, interim rate increases averaging approximately 20 percent were put into effect for most wholesale customers in July.

Outside financing

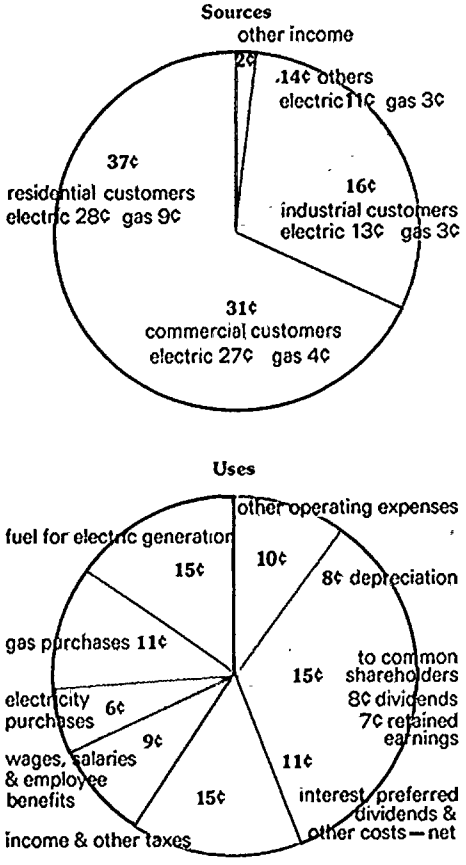
Two common stock offerings represented major sources of capital raised outside the company in 1978. Net proceeds from the issues were used to repay short-term debt incurred primarily in APS' construction program.

A June public offering of 2.5 million shares, priced at $19.75 per share, brought net proceeds of approximately $48 million. Approximately $67 million was raised following a November public offering of 3.5 million common shares which sold for $19.625 per share. In addition, we renegotiated $50 million in term loans with two of the company's principal banks which extended the maturities of these loans from 1979 to 1985 and brought in $20 million of new money, for a total loan of $70 million.

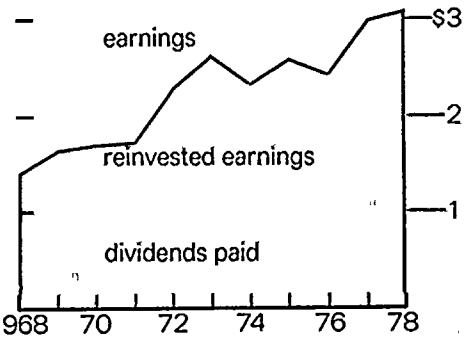
New permanent financing in 1979 will total approximately $300 million. Of this amount, some $150 million will come from the sale of mortgage bonds. The company has placed privately a 9.95 percent, $75 million first mortgage bond issue with closing dates scheduled in March and May, 1979, and plans another sale later in the year to raise an additional $75 million.

On February 14, 1979 the company sold 600,000 shares of $8.80 new cumulative preferred stock, Series K, $100 par value, priced at $100 per share. Net proceeds were approximately $59.3 million. Common stock totaling about four million shares and a possible pollution control bond issue are also planned for 1979.

1978 Income Dollar



Earnings, Dividends, Reinvested Earnings per Average Share of Common Stock



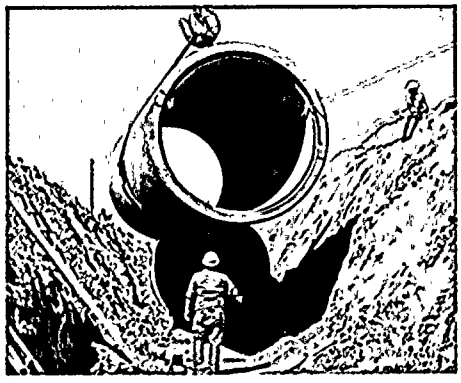
Common Stock Price Ranges (Symbol: AZP)

1978	High	Low	Dividend per Share
1st quarter	$21⅝	$19⅛	$ .42
2nd quarter	20⅝	18¾	.42
3rd quarter	21¼	19¼	.42
4th quarter	20⅞	19⅛	.47

1977	High	Low	Dividend per Share
1st quarter	$20	$18⅛	$ .37
2nd quarter	21	18⅝	.37
3rd quarter	21¼	19¾	.37
4th quarter	21⅜	19¼	.42

APS' total revenues reached a record $562.2 million, up $68.5 million, or 13.9 percent over 1977. Net income rose to $106.8 million, a 27.1 percent increase over the $84 million reported a year earlier.

Major expense items included fuel for electric generation and purchased power, $119.6 million; taxes, $83.3 million; purchased gas for resale, $63.3 million; net interest deductions, $46.9 million.



About 50 miles of precast concrete pipe will carry nearly 50,000 gallons of treated effluent per minute, from a Phoenix sewage treatment plant, to cool the Palo Verde Nuclear Generating Station.

Our Vital Growth

The continuing need for additional energy sources so vital to Arizona's growing economy is reflected in the record $389.3 million for capital expenditures in 1978, up from $295.9 million in 1977.

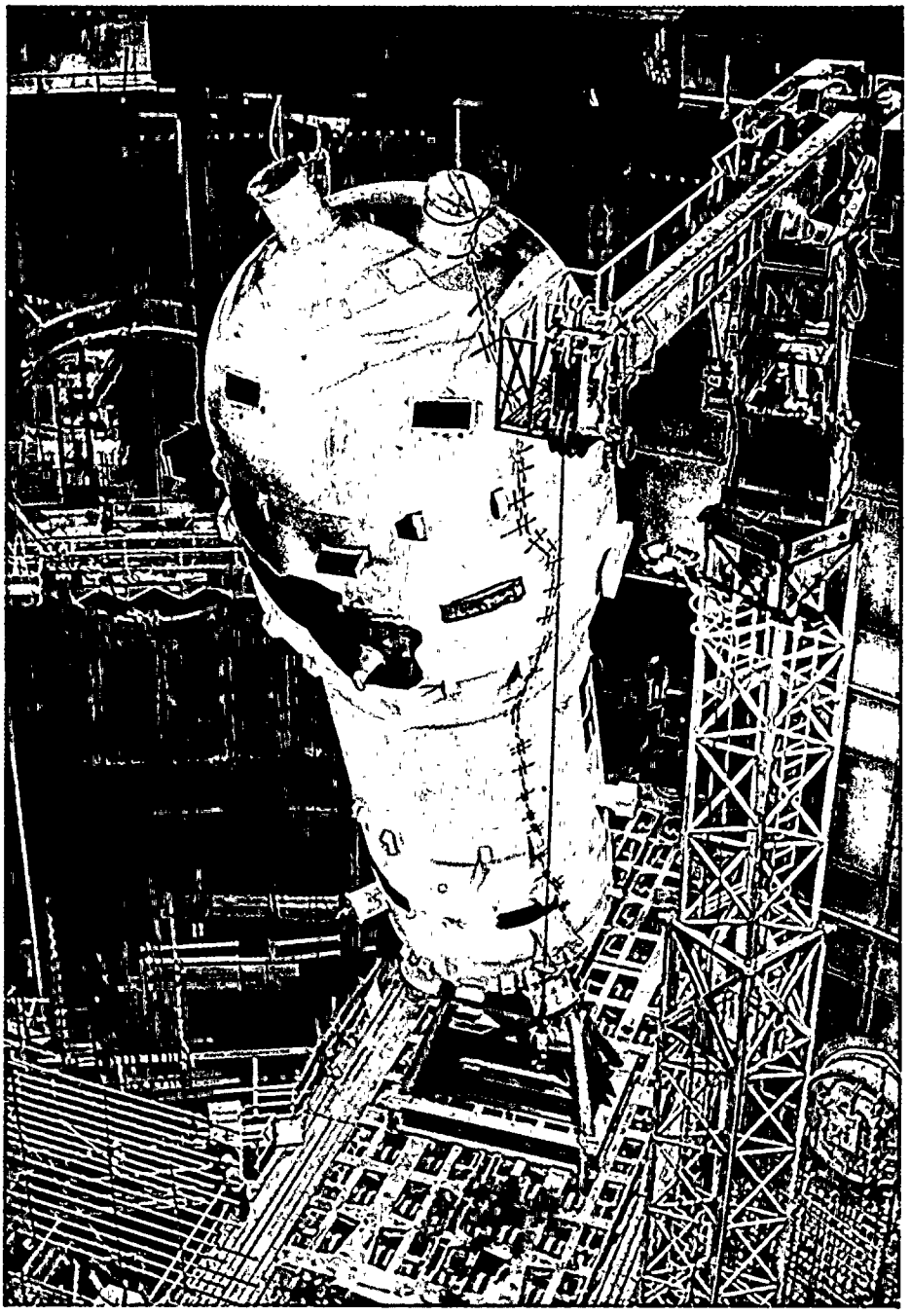
More than two-thirds of the money was earmarked for expansion of the coal-fired Cholla Power Plant and the company's share in the Palo Verde Nuclear Generating Station. Total expenditures for electric property and equipment, including environmental protection facilities, amounted to $385 million.

As a part of the Cholla expansion, APS completed a 500,000-volt transmission line to carry energy 206 miles from the plant in northern Arizona to a switchyard at our Saguaro Power Plant 30 miles north of Tucson. The $60 million line was energized in May.

Gas facilities accounted for only $4.3 million, reflecting the moratorium on new gas hookups in effect for most of the year.

While we are building these facilities, we're continuing our efforts to reduce operating and maintenance costs. New computer systems, hardware and equipment to improve efficiency were among major expense items included in the expenditures for facilities, equipment and property common to electric and gas systems.

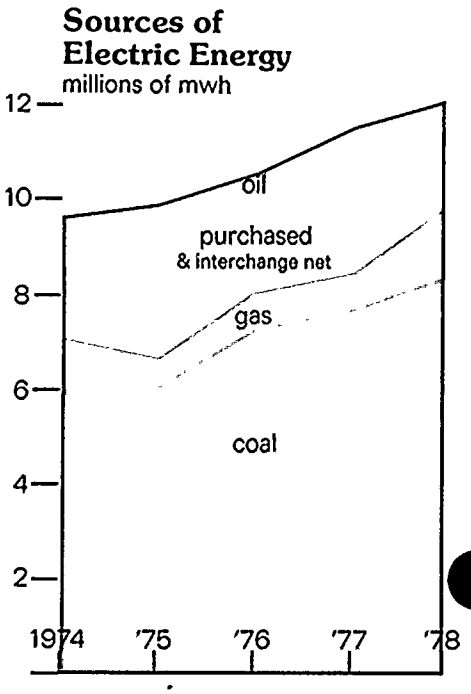
Capital expenditures for 1979 are estimated at $413.8 million but, from 1981 through 1983, reductions are anticipated, as the chart on page six indicates.

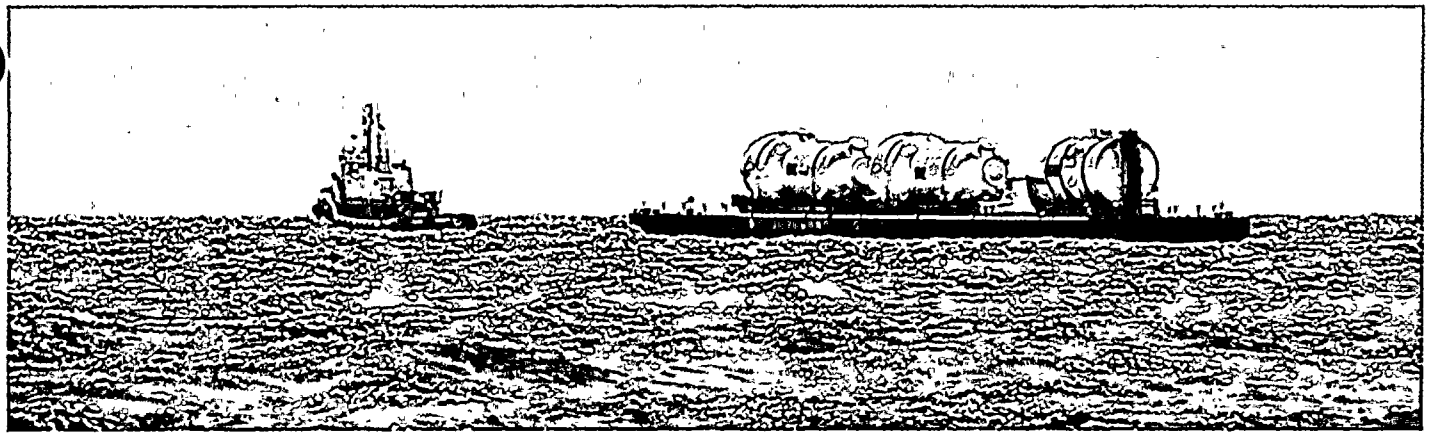


The 793-ton steam generators for Palo Verde's first unit were installed in the containment building using a special construction trolley and lift frame.

Building for tomorrow

Progress continues at the Palo Verde Nuclear Generating Station, the largest construction project in the state's history. The three 1,270,000-kilowatt units under construction 50 miles west of Phoenix will provide about one-fourth of Arizona's electric generation by 1986, at a lower cost than energy from





An ocean-going barge heads for Puerto Penasco, Mexico carrying 2,200 tons of equipment for the Palo Verde Plant. It had come from Chattanooga, TN, through the Panama Canal, and up the Gulf of California, a water journey of approximately 5,500 miles.

alternative sources.

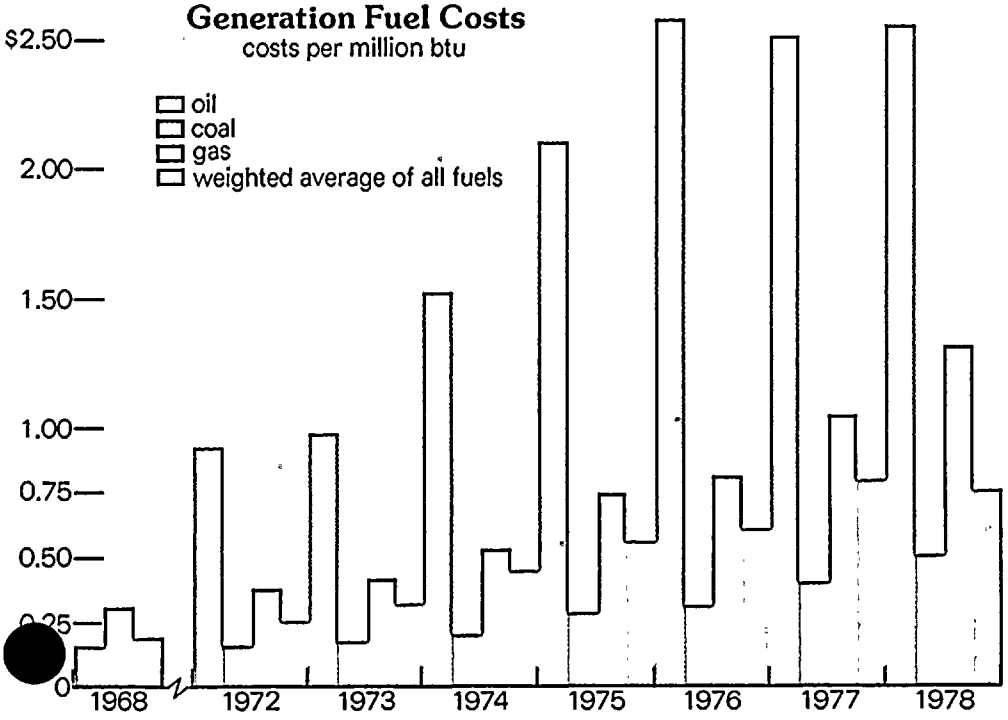
Aside from the fact that nuclear energy will produce electricity cheaper than either coal or oil, more economic benefits will flow to Arizona as millions of dollars in ad valorem taxes, from out-of-state participants, are added annually to Arizona's tax coffers. We have already seen significant economic impact as Palo Verde payroll dollars are used to purchase Arizona goods and services and to pay state sales, income and property taxes.

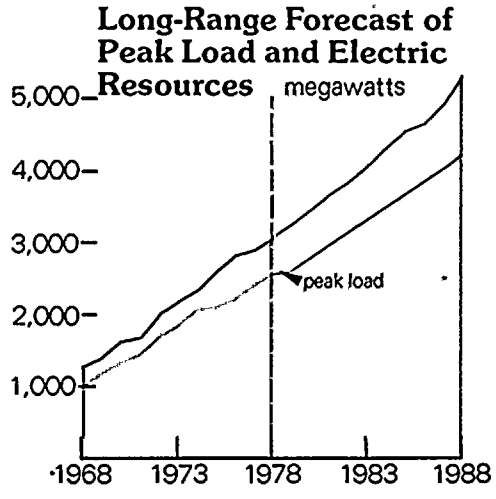
Total construction payroll for the $2.9 billion plant is expected to reach $640 million. Additionally, about $500 million will be spent in Arizona for materials and supplies.

The project employed 3,340 manual construction workers at year end, when Unit 1 was 32 percent complete and the overall project reached the 22.3 percent completion level.

APS is project manager and operating agent for Palo Verde, a joint effort of five southwestern utilities. Other participants are El Paso Electric Company, Public Service Company of New Mexico, the Salt River Project, and Southern California Edison Company.

A unique and innovative feature of the Palo Verde project is the use of sewage effluent as make-up water in the plant's condenser cooling system. The effluent will come from six communities in the metropolitan





Phoenix area. We'll take delivery at the City of Phoenix' 91st Avenue treatment plant, then transport the effluent underground through concrete pipe to the Palo Verde site.

Not only is this use of effluent unique, but an economic study by an independent research firm indicates that using the effluent for cooling, rather than for other purposes, would bring the highest economic benefits to the community and to state and local governments. Use of this water also leaves the area's surface and ground water supply available for other vital uses.

Last March, APS and 10 other western energy suppliers filed an application with the Federal Nuclear Regulatory Commission (NRC) for construction permits for two additional units at the Palo Verde site. The filing was made in accordance with NRC's replication policy, which will result in significant savings in design, siting, regulatory and construction costs.

APS' efforts to protect the environment extend to studying the habits of wildlife. With power lines slated to be constructed in the habitat of desert bighorn sheep, the company is participating in a study of this endangered species' behavior and diet patterns, to insure their existence will not be jeopardized by man's presence.

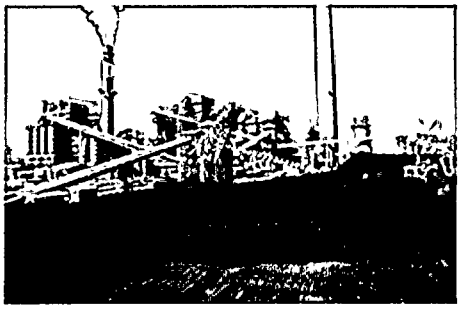
Approval for a certificate of environmental compatibility for the two units was granted in January, 1979 by the Arizona Corporation Commission. The construction application and environmental certificate do not, however, represent a final decision to proceed with construction of Units 4 and 5.

Our Concern for Today

Average residential use in 1978 was 9,918 kilowatt-hours, up 3.6 percent over 1977. One reason: most new customers were all-electric customers, with higher use levels.

At year-end, electric customers totaled 378,553, up 5.8 percent over 1977. Electric sales increased in nearly all retail categories, with the industrial category showing the largest percent gain, 12.1 percent, or 240,081 megawatt-hours. The residential category had the largest overall gain, 269,694 megawatt-hours.

This growth in both customer number and demand created a peak electric load in July of 2,548,900 kilowatts, 7.4 percent above the 1977 peak. Electric resources consisted of 2,795,700 kilowatts of generation plus 265,900 kilowatts of firm purchased power, for a total of 3,061,600 kilowatts.



Nearly 80 percent of the electricity APS generates comes from economical coal. The Cholla Power Plant (above)in northeastern Arizona, and the Four Corners Plant near Farmington, New Mexico, provide the lion's share.

A new 235,000-kilowatt coal-fired unit (Unit 2) went into service in June at our Cholla Power Plant near Joseph City. Completion of Cholla Units 3 and 4 has been delayed to better align with anticipated customer energy needs.

Unit 3, with a capacity of 250,000-kilowatts, is now scheduled for completion in 1980; the 350,000-kilowatt Unit 4 is targeted for 1981. The status of a fifth unit, originally scheduled for operation in 1983, is being reviewed, with the possibility of proceeding at a later date.

Reducing the peaks

Successful peak-trimming can help hold down our total construction budget and reduce the need for outside financing.

Due in part to a carefully thought-out array of innovative load-management programs, we have reduced our 10-year long-term construction forecast by $1 billion.

State legislation, passed during the year, is helping sell customers on the dozens of programs or devices that can help eliminate energy waste. Under the new law, certain energy-saving devices now qualify for state income tax credit.

Among these is HotTap, a device marketed by APS that uses waste heat from refrigerated air-conditioning units to heat water. Providing homeowners with essentially "free" water heating during air-conditioning months, HotTap has also brought significant savings to commercial customers. Success stories include a restaurant owner who estimates his HotTap installations will return his initial investment in just four months.

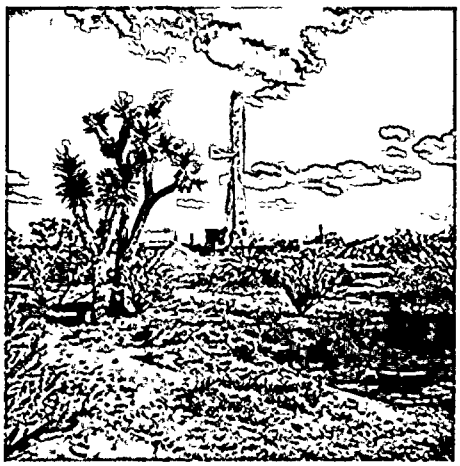
Continuing in 1979 are still other successful programs such as the Professional Home Energy Analysis, which helps a homeowner discover where energy is wasted. The analysis produces authoritative information on what improvements will cost and how much they'll save on home utility bills.

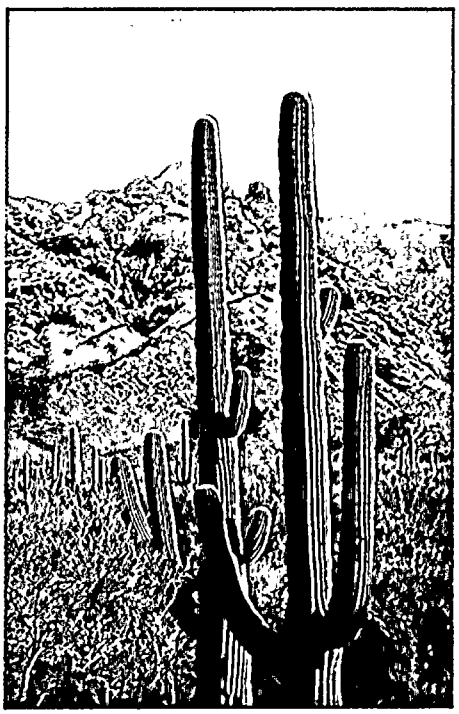
Also continuing are a series of energy audit seminars and energy products workshops for commercial and industrial customers. These help business operators cut waste, better manage energy use and cut their total energy demand.

So far these programs have helped reduce peak demand by an estimated 24,000 kilowatts in 1977 and an additional 29,000 kilowatts in 1978. If our objective for 1979 is reached, the cumulative effect of the three-year program will be a reduction in peak demand of nearly 85,000 kilowatts.

Through the years we have worked to provide energy to our customers from the most economical sources available. Additions of new coal-fired units at the Cholla Plant, and of nuclear units at Palo Verde, will further help limit the use of more expensive gas and oil as power plant fuels in the years ahead. In the mid-1980s, when Palo Verde units are on line, coal and nuclear fuels will provide nearly 94 percent of our energy needs.

In 1978, coal produced 79.6 percent of the electricity APS generated, while gas was the fuel for 14.3 percent and oil provided 6.1 percent of APS generation. In addition to our own resources, purchased power was used to meet 13.6 percent of our customers' energy needs.





APS began installing meters again in the fall of 1978 with the lifting of a moratorium on new natural gas customers. Extensive exploration for natural gas (top, right), launched in 1978, began paying off as the company had acquired over 2.4 billion cubic feet of proven reserves by mid-January, 1979. APS is also conducting a long-range uranium acquisition program. One exploration site is on a 40,000-acre tract near Wickenburg, Arizona (center, right). While contracts have been signed for enough uranium concentrate to supply three Palo Verde units through the end of this century, APS wants to assure supplies far into the future, and obtain more economical nuclear fuel by acquiring reserves now in the ground.

In 1978 APS, through its wholly-owned subsidiary, Bixco, Inc., launched a four-state search for natural gas in an effort to shore up future supplies and keep costs down. Bixco entered into exploration and drilling agreements with several companies, drilling exploratory wells in Texas, Oklahoma, Louisiana and New Mexico.

In December, the Arizona Corporation Commission issued an order allowing Bixco to use the full cost accounting method for rate making purposes in recovering costs of the 1978 program. Under the order, Bixco may recover exploration and development costs on a full-cost basis to be amortized over units of production. These costs are reflected in future gas rates.

The order approved expenditures of $14 million authorized by the board of directors for the 1978 program. The company has also asked the commission to approve Bixco's 1979 program, which would include expenditures of $14 million for exploration and development, plus an estimated $3.5 million for associated operating expenses.

Bixco's drilling efforts have resulted in APS' acquisition of over 2.4 billion cubic feet of proven reserves through mid-January, 1979. Anticipated production from Bixco's successful wells is estimated at 2.1 million cubic feet per day, which will be transported to the company's distribution system as required. Natural gas produced, but not required for APS' resale business, will be sold to El Paso Natural Gas Co. with proceeds used to reduce our distribution system gas costs.

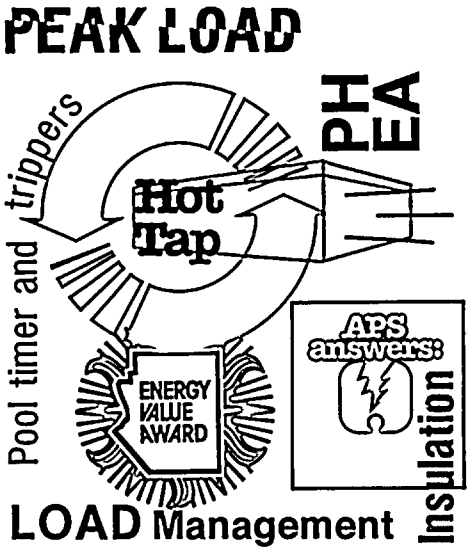
The improved availability of natural gas from our wholesale supplier, El Paso Natural Gas Co., and the initial success of our explorations, contributed to the Arizona Corporation Commission's decision to lift a moratorium on new gas services.

Balancing benefits with costs

Our commitment to balance environmental concerns with proven, cost-effective technology is evidenced by programs involving more than $200 million in capital costs to date.

These environmental programs have touched nearly every area of the company's operation. For example, an environmental improvement project is currently in its early design stages at the Four Corners Power Plant. Required to meet New Mexico air quality regulations, the project has a preliminary engineering estimate of $330 million, to be shared by all participants.

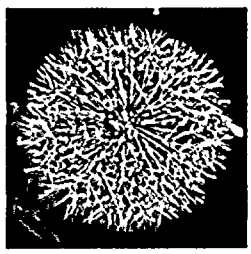
Customers are becoming active partners in finding ways to trim peak energy demands with minimum effect on lifestyles. One test involves use of load controllers, installed at customers' homes, to sequence major appliance operation and keep total electric demand below a preset level. Data from such tests will also provide information useful in developing future rate structures.



Design work on the system is proceeding in order to meet the New Mexico Environmental Improvement Board's compliance date of year-end 1982. However, there are uncertainties about Environmental Protection Agency (EPA) approvals and regulations yet to be promulgated under certain sections of the Clean Air Act (federal), as well as pending legal questions involving the Navajo Tribe (see page 32).

Additionally, air monitoring stations, located on high terrain surrounding the plant, have recorded levels of sulfur dioxide that indicate that the plant, as presently equipped, is in compliance with New Mexico ambient air standards. The company will ask New Mexico authorities to reconsider the need for the improvement program if final monitoring results confirm this preliminary evaluation.

The company has taken aggressive action, through discussion and through the courts, to remove uncertainties, since delays will only inflate the already heavy environmental costs borne by plant owners and their customers.



Our Search for Tomorrow

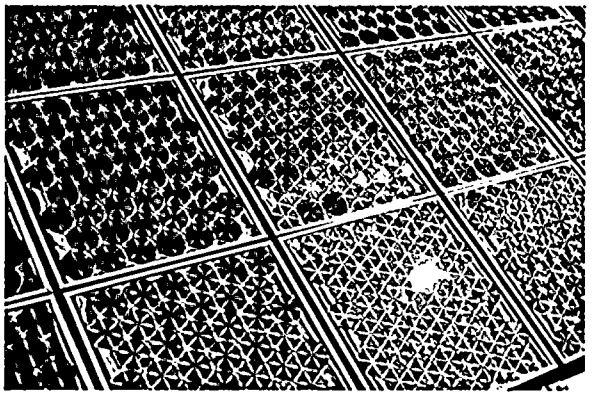
During 1978 we continued to explore new energy technologies and develop techniques that will help us provide for our customers' growing needs. We've been seeking ways to augment our existing generating facilities, as well as developing alternative energy sources that will help level generating peaks.

A major effort is being made in the area of solar energy. "Arizona — Solar Energy State" is a popular and valid slogan. And the search for ways to harness the sun's vast energy resources has been a corporate goal since APS sponsored the first world conference on solar energy in Phoenix more than 20 years ago.

Design of the world's largest direct conversion solar cell power plant — which would be built at Phoenix Sky Harbor International Airport — continues on schedule, with construction completion targeted for late 1980.

With funds to be provided mostly by the U.S. Department of Energy, we have joined with Motorola, Inc. to build the experimental 500-kilowatt Sky Harbor plant that will provide much of the energy required by the airport's new East Terminal. The State of Arizona is providing cooperative research support.

Another research project involves the addition of "solar repowering" equipment to our oil-fired Saguaro Power Plant near Tucson. With solar heated molten salts to flash water to steam for the turbines, the system would save nearly 7 million gallons of oil, and $4 million annually in fuel costs.



Helping to put the sun to work will be solar hardware like the Motorola Meinel optical module (top photo) which will convert sunlight directly into electricity. Some 14,000 will be used at the solar cell power plant APS hopes to build and operate at Phoenix Sky Harbor International Airport. Solar panels (lower left) are being used today to power APS radio repeaters in remote locations.

Secretary of Energy James Schlesinger and APS President Keith Turley discussed the role that solar and other energy sources will play in Arizona's future when the secretary visited Phoenix in 1978.

A vital research role

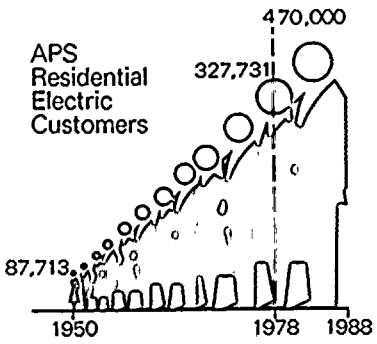
APS will directly contribute to and derive benefits from national research and development projects totaling more than $200 million. Many of these benefits will come from our active participation in the Electric Power Research Institute (EPRI), research arm of the U.S. utility industry. APS executives, scientists and engineers serve on EPRI study and advisory committees and on its board of directors, and regularly exchange research information with other member companies.

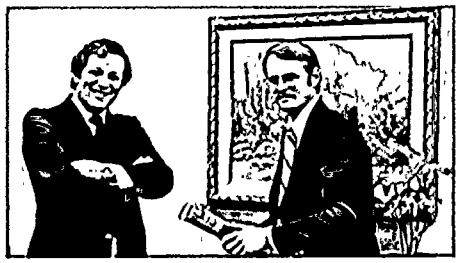
APS researchers are also playing national roles in advanced nuclear research and were instrumental in bringing together representatives from several utilities to assist in development and commercialization of high temperature gas-cooled nuclear reactors for powering gas turbines. Such reactors are more efficient and, particularly important to the water-conscious southwest, they require little water.

Looking toward cleaner, better ways to use coal, we are partners in a number of coal gasification research projects. We expect to find ways to both reduce the high cost of cleaning up coal-burning and improve plant efficiency.

In total, we're a vital part of a nationwide utility effort, one that will see utilities spend nearly $1.5 billion over the next five years in the development of new energy supply systems.

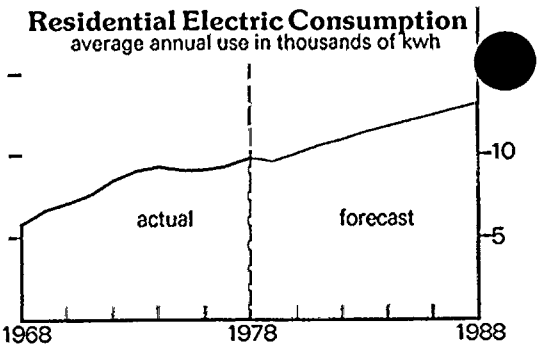
Our research dollars not only enhance our ability to serve our customers' future needs, but result in near-term improvements and efficiencies that show a very real payback.





O. Mark De Michele (left) joined the company in April as vice president of Corporate Relations, with responsibility for the company's public and community relations activities, marketing operations, advertising and communications programs. He was formally vice president of Public Relations at Niagara Mohawk Power Corporation, Syracuse, N.Y.

John C. Ogden was elected vice president of administration and economic planning by the board of directors in July. He's responsible for the company's audit, budget, productivity, materials management services and computer operations. He was manager of economic planning and control prior to the election.



Safety

Our ongoing safety program produced significant gains in 1978. Although the number of injuries resulting in lost time increased, the actual number of days lost as a result of these injuries was down slightly, and the incident rate — the number of medical treatment cases — showed a 33 percent decrease over the previous year.

We began the first phase of a three-part educational program to reduce back injuries. This has already reduced such injuries by 34 percent, and we expect further reduction as the second phase of the program reaches employees systemwide.

Our public safety efforts were highlighted by films on natural gas safety, and audiovisual programs, produced by the Pacific Coast Gas Association, for schools and civic groups.

We reached out to municipal fire departments to train their personnel in handling electric and natural gas fires and related emergencies. This program will be extended to law enforcement agencies in the months ahead.

Our Continuing Dialogue

The company's success at playing a leading role in the orderly development of Arizona's energy resources is closely tied to the success of its communication efforts. Shareholders, customers, employees, opinion leaders — all these and many others — have a stake in the company's future. Thus, we have stepped up our communication and education efforts in an attempt to reach these diverse audiences. The major goal is to provide each with meaningful information tailored to their interests and concerns, as well as explaining how APS plans to meet the needs of a growing Arizona.

To obtain an accurate reading of Arizona leaders' opinions on energy questions and to explore the potential for community support, APS conducted a leadership survey in 1978. Some 137 community leaders in the Phoenix and Tucson metropolitan areas participated.

The survey unearthed a number of areas of growing concern; among them were growth and energy. The two are interdependent. Our company holds primary responsibility for the key area, energy, and our efforts in this area are recognized and supported.

We hope to open constructive dialogue among leaders, to involve them more directly in confronting these challenges and to make them more aware of what we are doing to meet our state's energy needs.

Continuing strong leadership within our company is also important to insuring Arizona's long-term energy supplies. With this in mind, our ongoing employee development program was expanded in 1978 to include a system for identifying employees with high potential for managerial positions. Training programs were implemented to groom these employees for added responsibility. The goal is to provide even better employees who can meet tomorrow's needs and, at the same time, improve our efficiency right now.

The first management academy, conducted through the Arizona State University business college, was held in 1978 for a small group of employees with high leadership potential. During an intensive three-week course, these employees received extensive training in management skills and an overview of utility operations. Several academy participants have already moved up to assume key positions within the company.

Recognizing the needs of women, who continue to take on more responsible positions with APS, the company sponsored its first energy seminar for women employees.

Surveys were conducted among employees and our customers to determine their opinions about APS and energy-related issues. Results of the surveys have helped the company develop communication programs that effectively deal with these issues.

The customer survey showed improved support of our efforts to provide good, reliable service. This was particularly gratifying, since it affirms the validity of service principles APS has espoused through the years.

Responding to customers' needs, our communication efforts support load management goals by making information on effective energy use more accessible.

Our customers want to know what we are doing to meet the energy needs of a growing state. A new information center (above) at the Palo Verde Plant opened in 1978 to explain how Palo Verde works and why it's needed. The center offers bonus information: it will be heated and cooled by solar energy. APS' customer information programs include intensive training for employees who must answer questions from today's more knowledgeable customers. We have published a system-wide report to customers and public, and are using a more informative monthly bill. Company officers and board members fielded questions from shareholders at meetings in Tucson and Sun City.

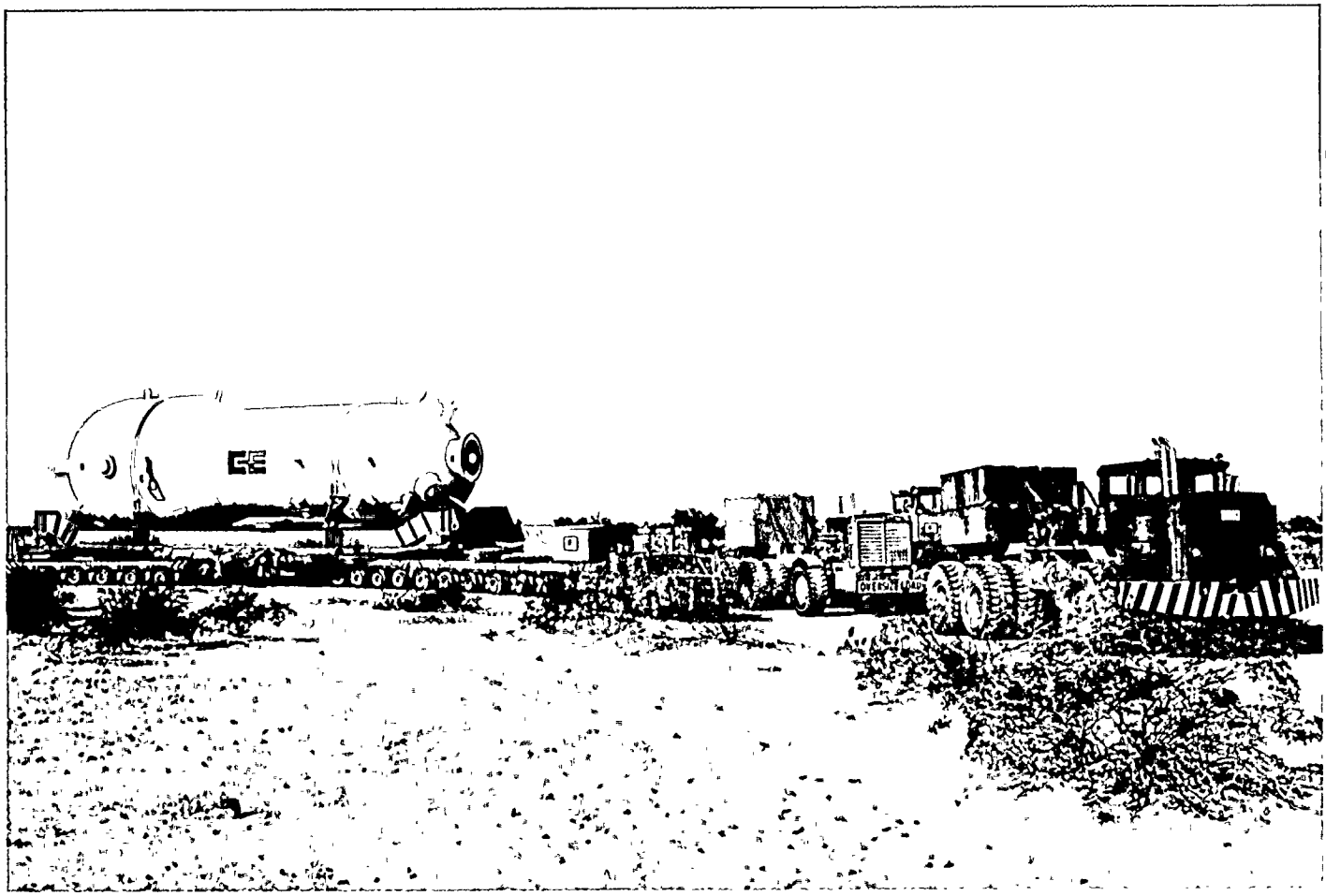
Installing a statewide toll-free telephone number for customer inquiries, initiating a report to customers, implementing a balanced payment plan to help customers even out energy bills and revitalizing our popular Speakers Bureau were some of the efforts made to increase our dialogue with the people we serve.

The customer survey also showed Arizonans continue to support construction of the Palo Verde Nuclear Generating Station. We're working for better understanding of the facts about nuclear power by increased communication with the media, intensifying efforts to reach more audiences and making more speaking presentations on nuclear energy.

The new energy information center at the Palo Verde construction site represents a key element in the company's communication program. The center is complete with small theater, energy exhibits and a time-lapse film condensing the project's two years of construction into just two minutes. The public and shareholders are invited to visit.

To answer employee needs for more and better information, APS' internal communications took on a new dimension in 1978 with the advent of "Dateline APS," the company's monthly videotaped news program, an innovative way to keep employees informed about issues affecting the company and the utility industry. Videotape has also become a valuable tool for safety, training and recruiting programs where a picture says a thousand words.

The company's ongoing communication efforts include special employee programs. Managers and key personnel were briefed by experts such as John Childs, vice president, Kidder Peabody & Co.



The reactor vessel and steam generators for Palo Verde Unit 1 travelled overland the final 200-mile leg of their 5,500-mile journey from Chattanooga. They're now in place at the plant site, being readied for operation in 1982 when Unit 1 will begin generating 1,270,000 kilowatts of electricity for customers in one of the fastest growing areas of the nation.

SUMMARY OF OPERATIONS

	1978	1977	1976	1975	1974
	(Thousands of Dollars)				
Operating Revenues	$ 562,217	$ 493,684	$ 394,779	$ 359,747	$ 273,599
Operating Expenses:					
Operating and maintenance expenses	291,908	269,581	215,500	196,475	153,006
Depreciation and amortization	48,295	40,370	36,621	32,793	26,398
Taxes*	83,314	71,885	59,617	56,414	38,413
Total	423,517	381,836	311,738	285,682	217,817
Other Income*	14,914	12,662	26,301	22,003	17,065
Interest Deductions	46,855	40,499	48,863	39,572	35,890
Net Income	$ 106,759	$ 84,011	$ 60,479	$ 56,496	$ 36,957
Preferred Dividend Requirements	$ 17,471	$ 14,628	$ 13,311	$ 10,422	$ 6,258
Earnings for common stock	$ 89,288	$ 69,383	$ 47,168	$ 46,074	$ 30,699
Common Stock Data:					
Book value per share	$ 22.56	$ 21.83	$ 20.64	$ 19.98	$ 20.13
Earnings per average share of common stock outstanding	$ 3.15	$ 3.02	$ 2.47	$ 2.60	$ 2.34
Dividends paid per share	$ 1.73	$ 1.53	$ 1.39	$ 1.36	$ 1.36
Shares of common — year end	32,777,258	26,576,428	22,500,000	19,000,000	15,000,000
— average	28,363,223	22,970,741	19,105,191	17,739,726	13,102,740
Number of common shareholders	78,275	66,358	56,011	56,003	43,497

*Federal and State income taxes are included in Taxes, Other Income and, in 1977, Interest Deductions. Total income tax expense (credit) was as follows (in thousands): 1978, $13,937; 1977, $6,265; 1976, $1,554; 1975, $2,122; 1974, $(2,664).

Comments on the Summary of Operations

Increases in operating revenues and expenses reflect increases in unit sales of electricity. Operating revenues also reflect rate increases (some of which are subject to refund) and effects of adjustment clauses.

The increase in unit sales of electricity was less in 1978 than in previous years because of declines in sales for irrigation (due to heavy rainfall) and in sales to wholesale customers (principally one that serves a large copper mine which has discontinued operations). Conservation efforts by customers in reaction to higher energy costs have affected unit sales for the past several years. Offsetting factors resulted in 1976 and 1977 from a significant increase in wholesale sales and in 1977 and 1978 from extraordinarily warm summers. Unit sales of gas are substantially affected by weather conditions, but have declined in the past because of a moratorium on new gas connections (which was recently lifted) and service curtailments by the company.

In addition to the effect of volume increases on operating expenses, the cost of fuel used for the generation of a given amount of electricity has risen, as has the unit price paid by the Company for gas purchased by it for resale. The rise in generating fuel cost was particularly acute in 1977 due to a renegotiated coal contract, higher priced boiler gas and the necessity for burning more oil to meet demand growth and to replace hydroelectric power formerly available from other sources. A subsequent decrease in 1978 was largely due to a favorable change in fuel mix resulting from unusually large supplies of boiler gas and from the startup of coal-fired Cholla Unit 2.

Maintenance expense has increased with system size and age and a particularly intensive program at the Four Corners Plant. Depreciation and amortization expenses and taxes (other than income) increase with the size of the company's utility plant, and both property and sales taxes increase with the amount of the

company's operating income. Fluctuations in income tax expense are shown in Note 5 of Notes to Financial Statements.

The principal component of other income is a portion (and before 1977 all) of the allowance for funds used during construction, the total amount of which is primarily a function of construction work in progress during a given period; see Note 1 of Notes to Financial Statements for changes in the rate of the allowance and the presentation of related tax benefits. Interest deductions have increased substantially with the incurrence of large amounts of new long-term debt and liability.

Recent issues of preferred stock (which increase the dividend requirements) and common stock (which increase the average number of shares outstanding) are summarized on pages 26 and 27.

The company's net income and its earnings for common stock represent composites of cash and non-cash items (see the Statement of Changes in Financial Position) and, in part, reflect accounting practices unique to regulated public utilities. See Note 7 of Notes to Financal Statements for certain contingencies.

OTHER FINANCIAL AND OPERATING STATISTICS

	1978	1977	1976	1975	1974
	(Thousands of Dollars)				
Capitalization:					
Common equity	$ 739,349	$ 580,170	$ 464,410	$ 379,535	$ 302,009
Preferred stock	218,561	218,561	168,561	168,561	138,561
Long-term debt	763,450	701,917	673,639	595,569	340,976
Project financing liability	127,723	53,617	—	—	—
Total	$ 1,849,083	$ 1,554,265	$1,306,610	$1,143,665	$ 781,546
Utility Plant — Gross	$ 2,288,605	$ 1,889,320	$1,580,672	$1,368,370	$1,190,399
Utility Plant — Depreciated	$ 1,901,044	$ 1,547,486	$1,279,533	$1,103,569	$ 955,399
Number of Employees at Year End	4,951	4,570	4,042	3,731	3,898
Average Wage per Hour	$ 8.57	$ 7.99	$ 7.44	$ 6.82	$ 6.16
Electric:					
Electric resources (kw)	3,061,600	2,872,500	2,790,700	2,568,700	2,343,600
Peak load (kw)	2,548,900	2,373,400	2,190,900	2,068,300	2,032,000
Electric sales — total (mwh)	10,912,704	10,481,972	9,606,571	8,892,570	8,692,304
Number of customers at year end	378,553	357,884	342,059	331,382	323,094
Gas:					
Total gas sales (m therms)	449,451	463,643	491,007	526,659	518,999
Number of customers at year end	339,803	339,949	339,265	336,839	334,908

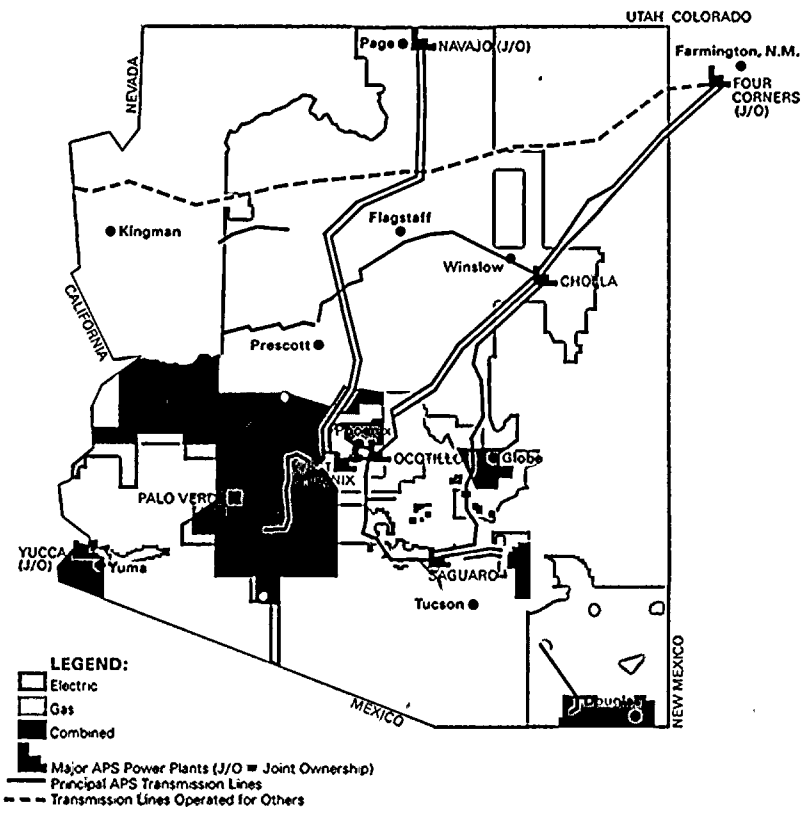
LINES OF BUSINESS

Operating revenues, and operating income before income taxes, attributable to electric and gas operations of the company during the five years ended December 31, 1978 were as follows:

	Operating Revenues (Millions of Dollars)				Operating Income Before Income Taxes (Millions of Dollars)			
	Electric		Gas		Electric		Gas	
Year Ended December 31,	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
1978	$452.4	80.5	$109.8	19.5	$141.0	92.4	$11.6	7.6
1977	397.3	80.5	96.4	19.5	109.2	91.3	10.4	8.7
1976	312.0	79.0	82.8	21.0	78.8	88.0	10.7	12.0
1975	281.1	78.1	78.7	21.9	70.6	87.2	10.4	12.8
1974	213.3	78.0	60.3	22.0	49.6	89.2	6.0	10.8

OPERATING REVENUES

	1978	1977	% Increase (Decrease)	1976	1975	1974
	(Thousands of Dollars)			(Thousands of Dollars)		
Electric:						
Residential	$158,383	$135,274	17.1	$106,334	$ 98,420	$ 74,348
Commercial	155,669	135,585	14.8	108.506	97,508	71,220
Industrial	72,677	61,617	17.9	47,055	40,737	31,502
Irrigation	12,252	13,512	(9.3)	9,799	9,669	6,387
Other	41,716	39,657	5.2	28,565	21,880	18,425
Total	440,697	385,645	14.3	300,259	268,214	201,882
Transmission for others	9,021	9,328	(3.3)	9,591	10,598	9,216
Miscellaneous services	2,713	2,291	18.4	2,119	2,268	2,173
Total Electric Operating Revenue	452,431	397,264	13.9	311,969	281,080	213,271
Gas:						
Residential	53,879	48,351	11.4	42,922	42,096	32,058
Commercial	24,223	20,779	16.6	17,156	15,761	11,412
Industrial	17,646	13,219	33.5	10,130	8,760	7,818
Irrigation	11,969	12,359	(3.2)	10,979	10,639	7,877
Other	1,169	860	35.9	830	652	441
Miscellaneous services	900	852	5.6	793	759	722
Total Gas Operating Revenue	109,786	96,420	13.9	82,810	78,667	60,328
Total Operating Revenues	$562,217	$493,684	13.9	$394,779	$359,747	$273,599



ABOUT THE COMPANY

Arizona Public Service is engaged principally in the generation and sale of electricity and in the purchase and sale of natural gas.

Successor to a series of small utility operations originating in 1886, the Company was incorporated in 1920 under the laws of Arizona.

The Company's service territory includes all or part of 11 of Arizona's 14 counties. It is estimated that the company's electric and/or natural gas service reaches approximately 1,735,000, or about 70% of the state's population.

Arizona Public Service Company's principal executive offices are located at 411 North Central Avenue, Phoenix, Arizona. Phone (602) 271-7900.

Shareholder Information

Stock Listing
(Symbol: AZP)
Common stock of the company and the $10.70 cumulative preferred stock, Series I, are listed for trading on the New York Stock Exchange. Common stock is also listed on the Pacific Stock Exchange.

Transfer Agents
First National Bank of Arizona,
Phoenix, Arizona
Irving Trust Company,
New York, N.Y.
(Common stock only)

Registrars
The Valley National Bank of Arizona
Phoenix, Arizona
Irving Trust Company,
New York, N.Y.
(Common stock only)

General Counsel
Snell & Wilmer, Phoenix, Arizona

Auditors
Deloitte Haskins & Sells,
Phoenix, Arizona

Dividend Reinvestment and Stock Purchase Plan
A Prospectus describing this plan for holders of the company's Common stock is available to shareholders upon request. Write: Office of the Secretary, Sta. 1892, at the address below.

Form 10-K
A copy of our Annual Report to the Securities and Exchange Commission, Form 10-K, will be available after March 31, 1979 without charge, upon written request of shareholders. Write: Office of the Secretary, Sta. 1892, at the address below.

Statistical Report
A detailed Statistical Report for Financial Analysis 1968-1978 will be available by mid-April on request. Direct inquiries to George H. Toler, treasurer, at the address below.

Mailing Address:
P.O. Box 21666
Phoenix, Arizona 85036

STATEMENTS OF INCOME

For the Years Ended December 31, 1978 and 1977 and Comparison

	1978	1977	Increase (Decrease)
	(Thousands of Dollars)		
Operating Revenues (Note 7):			
Electric	$ 452,431	$ 397,264	$ 55,167
Gas	109,786	96,420	13,366
Total	562,217	493,684	68,533
Operating Expenses:			
Operating and maintenance expenses:			
Fuel for electric generation	88,426	85,575	2,851
Purchased gas	63,314	53,232	10,082
Purchased power and interchange — net	31,218	32,431	(1,213)
Other production expenses	10,724	9,434	1,290
Transmission and distribution	12,985	12,224	761
Maintenance	41,845	36,660	5,185
Other operating expenses	43,396	40,025	3,371
Total	291,908	269,581	22,327
Depreciation and amortization	48,295	40,370	7,925
Taxes — other than income	69,397	64,227	5,170
Income taxes (Note 5)	13,917	7,658	6,259
Total	423,517	381,836	41,681
Operating Income	138,700	111,848	26,852
Other Income:			
Allowance for equity funds used during construction	16,536	15,891	645
Income taxes (Note 5)	(20)	(373)	353
Other — net	(1,602)	(2,856)	1,254
Total	14,914	12,662	2,252
Gross Income	153,614	124,510	29,104
Interest Deductions:			
Interest on long-term debt and liability (Note 2)	66,152	53,926	12,226
Interest on short-term borrowings	2,566	1,956	610
Amortization of debt discount, premium and expense	644	613	31
Allowance for borrowed funds used during construction — credit (Note 2)	(22,507)	(15,996)	(6,511)
Total	46,855	40,499	6,356
Net Income	106,759	84,011	22,748
Preferred Dividend Requirements	17,471	14,628	2,843
Earnings for Common Stock	$ 89,288	$ 69,383	$ 19,905
Average Common Shares Outstanding	28,363,223	22,970,741	5,392,482
Per Share of Common Stock:			
Earnings (based on average shares outstanding)	$3.15	$3.02	$.13
Dividends declared	$1.73	$1.53	$.20

See Notes to Financial Statements, including Note 1 as to significant accounting policies.

BALANCE SHEETS

December 31, 1978 and 1977

Assets	1978	1977
	(Thousands of Dollars)	
Utility Plant:		
Plant in service (Notes 2 and 4):		
Electric	$1,499,005	$1,099,932
Gas	124,500	123,407
Common, used in all services	47,678	42,868
Total	1,671,183	1,266,207
Less accumulated depreciation and amortization	387,560	341,834
Plant in service — depreciated	1,283,623	924,373
Construction work in progress (Notes 2 and 4)	611,309	619,147
Plant held for future use	6,112	3,966
Utility plant — depreciated	1,901,044	1,547,486
Investments and Other Assets:		
Investments in and receivables from subsidiaries	8,116	7,335
Other investments and notes receivable	3,180	4,542
Other physical property (less accumulated depreciation: 1978, $36,000; 1977, $29,000)	994	1,354
Total investments and other assets	12,290	13,231
Current Assets:		
Cash (Note 3)	4,101	3,969
Special deposits and working funds (Note 3)	2,063	2,075
Accounts receivable:		
Service customers	50,708	36,759
Miscellaneous	11,374	7,918
Allowance for doubtful accounts	(1,528)	(1,293)
Materials and supplies (at average cost)	22,002	15,280
Fuel (at average cost)	16,843	23,425
Prepayments and other	9,636	7,543
Total current assets	115,199	95,676
Deferred Debits:		
Deferred interest	—	4,486
Unamortized debt issue costs	5,381	5,472
Other	5,506	6,820
Total deferred debits	10,887	16,778
Total	$2,039,420	$1,673,171

Liabilities	1978	1977
	(Thousands of Dollars)	
Capitalization:		
Common stock	$ 81,943	$ 66,441
Premiums and expenses	429,476	326,744
Retained earnings (Note 2)	227,930	186,985
Common stock equity	739,349	580,170
Preferred stock	218,561	218,561
Long-term debt, less current maturities	763,450	701,917
Project financing liability (Note 2)	127,723	53,617
Total capitalization	1,849,083	1,554,265
Current Liabilities:		
Commercial paper (Note 3)	39,000	—
Current maturities of long-term debt	4,594	552
Accounts payable	66,192	47,410
Accrued taxes	45,896	39,739
Accrued interest	12,786	11,106
Accrued dividends on preferred stock	1,456	1,456
Customers' deposits, advances and other	6,478	9,738
Total current liabilities	176,402	110,001
Deferred Credits and Other:		
Customers' advances for construction	5,450	5,733
Deferred income taxes	3,601	1,000
Other	4,884	2,172
Total deferred credits and other	13,935	8,905
Commitments and Contingencies (Note 7)		
Total	$2,039,420	$1,673,171

See Notes to Financial Statements, including Note 1 as to significant accounting policies.

STATEMENTS OF CHANGES IN FINANCIAL POSITION

For the Years Ended December 31, 1978 and 1977

	1978	1977
	(Thousands of Dollars)	
Source of Funds:		
Funds from operations:		
Net income	$106,759	$ 84,011
Principal non-fund charges (credits) to income:		
Depreciation and amortization	48,295	40,370
Equity in undistributed loss of unconsolidated subsidiaries	1,754	3,043
Deferred income taxes	2,601	27
Allowance for equity funds used during construction	(16,536)	(15,891)
Total funds from operations	$142,873	$111,560
Funds from external sources:		
Common stock	$118,558	$ 81,660
Preferred stock	—	49,425
Long-term debt	66,300	27,940
Project financing liability	74,106	53,617
Short-term borrowings — net	39,000	—
Sale of investment	—	4,983
Total funds from external sources	297,964	217,625
Other items — net	10,946	2,332
Decrease in working capital*	3,836	16,473
Total source of funds	$455,619	$347,990
Application of Funds:		
Capital expenditures	$405,789	$311,773
Allowance for equity funds used during construction	(16,536)	(15,891)
Funds used for capital expenditures	389,253	295,882
Repayment of long-term debt	552	3,013
Dividends on preferred and common stock	65,814	49,095
Total application of funds	$455,619	$347,990
Increase (Decrease) in Working Capital*:		
Cash	$ 132	$ 1,389
Accounts receivable	17,170	4,792
Materials, supplies and fuel	140	2,299
Accounts payable and accrued expenses	(26,619)	(26,264)
Customers' deposits, advances and other	3,260	2,311
Other — net	2,081	(1,000)
Net decrease in working capital	$ (3,836)	$ (16,473)

*Excluding short-term borrowings — net and current maturities of long-term debt.

STATEMENTS OF RETAINED EARNINGS

For the Years Ended December 31, 1978 and 1977

	1978	1977
	(Thousands of Dollars)	
Retained earnings at beginning of year	$186,985	$152,069
Add —Net income	106,759	84,011
Total	293,744	236,080
Deduct — Dividends:		
Preferred stock	17,471	14,628
Common stock	48,343	34,467
Total	65,814	49,095
Retained earnings at end of year	$227,930	$186,985

See Notes to Financial Statements including Note 1 as to significant accounting policies.

LONG-TERM DEBT

December 31, 1978 and 1977

	1978	1977
	(Thousands of Dollars)	
First Mortgage Bonds:		
3% series due April 1, 1979	$ 4,000	$ 4,000
2¾% series due February 1, 1980	5,000	5,000
9.80% series due June 1, 1980	75,000	75,000
2⅞% series due December 1, 1980	6,000	6,000
9.50% series due February 15, 1982	100,000	100,000
3½% series due February 1, 1983	14,500	14,500
3½% series due November 1, 1983	5,723	5,723
3¼% series due March 1, 1984	15,000	15,000
5⅛% series due October 1, 1987	15,000	15,000
4.70% series due March 1, 1989	20,000	20,000
4.80% series due November 1, 1991	35,000	35,000
4.45% series due June 1, 1992	25,000	25,000
4.40% series due December 1, 1992	25,000	25,000
4.50% series due September 1, 1993	15,000	15,000
6.25% series due September 1, 1997	25,000	25,000
10.625% series due November 15, 2000	75,000	75,000
7.45% series due March 15, 2002	60,000	60,000
6.20% series due April 1, 2004	50,000	50,000
6.45% series due April 15, 2007	43,000	43,000
6% series due January 15, 2008	34,000	—
Less securities held by trustees (a)	(2,005)	(14,039)
Unamortized discount and premium	(840)	(933)
Total First Mortgage Bonds	644,378	598,251
Unsecured Notes Payable	70,000(b)	50,000
Capitalized Lease Obligation (c)	53,666	54,218
Total Long-Term Debt	768,044	702,469
Less Current Maturities:		
3% series due April 1, 1979	(4,000)	—
Capitalized lease obligation	(594)	(552)
Total Long-Term Debt Less Current Maturities	$763,450	$701,917

(a) Representing pollution control funds deposited with a revenue bond trustee to be disbursed as construction of the facilities being financed progresses.

(b) Consisting of $30,000,000 payable in thirteen equal quarterly installments commencing June 1, 1983 or, under certain conditions, in ten equal quarterly installments commencing June 1, 1984, with interest at 105% of prime through September 1, 1979 to 110% of prime plus ½ of 1% after September 1, 1984; and $40,000,000 due February 1, 1985, with interest through September 1, 1979 at 103% of the higher of prime or ½ of 1% above the current rate on 90 to 119 day dealer-placed commercial paper, to 115% thereof after September 1, 1981.

(c) Represents the present value of future lease payments (discounted at the interest rate of 7.48%) of a combined cycle plant sold and leased back from the independent owner-trustee formed to own the facility. The lease requires semi-annual payments of $2,299,000 through June 1983 and, then, $2,582,000 through June 2001, and includes renewal and purchase options based on fair market value. This plant is included in plant in service at its original cost of $54,405,000; accumulated amortization at December 31, 1978 was $5,558,000.

Aggregate annual payments which will be due on long-term debt and for sinking fund requirements through 1983 are as follows: 1979, $4,594,000; 1980, $86,639,000; 1981, $3,688,000; 1982, $103,740,000; 1983, $24,302,000. Other sinking fund requirements through 1983 for the outstanding First Mortgage Bonds (which may be met by property additions) will be as follows: 1979, $2,662,000; 1980 through 1982, $2,552,000; 1983, $2,350,000; as allowed in the bond indentures, requirements of this type have in the past been satisfied by certification of property additions of 1-2/3 times the amount stated and the company expects to meet similar requirements in that manner in the future. For sinking fund requirements and redemptions at the option of the holders of cumulative preferred stock, beginning in 1979, see Capital Stock; for requirements under project financing, see Note 2.

Substantially all utility plant, other than the combined cycle plant mentioned above and the construction work in progress for Cholla Unit 4 (see Note 2), is subject to the lien of the First Mortgage Bonds. The indenture respecting the First Mortgage Bonds includes provisions which would restrict the payment of dividends on Common Stock under certain conditions which did not exist at December 31, 1978.

CAPITAL STOCK

For the Years Ended December 31, 1978 and 1977

CLASS	Number of Shares			Par Value			Call Price Per Share
	Authorized	Outstanding		Per Share	Outstanding (Thousands of Dollars)		(Before Adding Accumulated Dividends)
		1978	1977		1978	1977	
Common Stock	50,000,000	32,777,258	26,576,428	$ 2.50	$ 81,943	$ 66,441	
Cumulative Preferred Stock:							
$1.10 preferred	160,000	155,945	155,945	25.00	$ 3,898	$ 3,898	$ 27.50
$2.50 preferred	105,000	103,254	103,254	50.00	5,163	5,163	51.00
$2.36 preferred	120,000	40,000	40,000	50.00	2,000	2,000	51.00
$4.35 preferred	150,000	75,000	75,000	100.00	7,500	7,500	102.00
Subtotal	535,000	374,199	374,199		18,561	18,561	
Serial preferred:							
$2.40 series A		240,000	240,000	50.00	12,000	12,000	50.50
$2.625 series C		240,000	240,000	50.00	12,000	12,000	51.00
$2.275 series D		200,000	200,000	50.00	10,000	10,000	(a)
$3.25 series E		320,000	320,000	50.00	16,000	16,000	(b)
Subtotal	1,000,000	1,000,000	1,000,000		50,000	50,000	
Serial preferred:							
$8.50 series F		210,000	210,000	100.00	21,000	21,000	(c)
$8.50 series G		90,000	90,000	100.00	9,000	9,000	(c)
$10 series H		400,000	400,000	100.00	40,000	40,000	(d)
$10.70 series I		300,000	300,000	100.00	30,000	30,000	(e)
$8.32 series J		500,000	500,000	100.00	50,000	50,000	(f)
Subtotal	4,000,000	1,500,000	1,500,000		150,000	150,000	
Serial preferred	3,000,000	—	—	25.00	—	—	
TOTAL	8,535,000	2,874,199	2,874,199		$218,561	$218,561	

(a) From $51.00 through February 29, 1980; then to $50.50 thereafter.

(b) From $51.50 through February 28, 1983; then to $51.00 thereafter.

(c) Redeemable at par after May 30, 1979 (series F) or May 30, 1982 (series G) at the option of either the Company or the holders. Both series are also subject to redemption at par at the demand of the holders prior to the foregoing dates under certain conditions, which did not exist at December 31, 1978. Sinking fund provisions applicable to the two series require the retirement of a total of 12,000 shares at par semi-annually commencing June 1, 1979 (representing annual payments of $2,400,000).

(d) Not redeemable prior to September 1, 1984 through certain refunding operations; otherwise at $108.60 through September 1, 1979 to par after September 1, 2002. Applicable sinking fund provisions require the retirement of 16,000 shares at par annually commencing September 1, 1979 (representing annual payments of $1,600,000).

(e) Not redeemable prior to December 1, 1985 through certain refunding operations; otherwise at $110.70 through November 30, 1980 to $101.00 after November 30, 1990. Applicable sinking fund provisions require the retirement of 15,000 shares at par annually commencing December 1, 1981 (representing annual payments of $1,500,000). The Company may, but is not required to, redeem an additional 15,000 shares at par on December 1 in any year beginning in 1981.

(f) Not redeemable prior to September 1, 1982 through certain refunding operations; otherwise at $108.32 through August 31, 1982 to $101.00 after August 31, 1992.

In the opinion of counsel, amounts paid in any redemption of capital stock funded other than with the proceeds of a concurrent new issue of capital stock would reduce the amount of retained earnings available under Arizona law for the payment of dividends. Because of the option of the holders thereof to require redemption of the series F and G shares as indicated in note (c) above, the company considers that a portion of its retained earnings which is equal to the aggregate par value of such series ($30,000,000) is unavailable for dividend payments.

The Company has a dividend reinvestment and stock purchase plan whereby newly issued shares of its Common Stock may be purchased at market on the applicable dates by any participant in the plan. It also has an employee savings plan under which its own

periodic contributions probably would, and the investment of certain funds contributed by participating employees could, involve its issuance of new shares of Common Stock.

Capital stock sales and changes in premiums and expenses during the years ended December 31, 1977 and 1978 were as follows (dollars in thousands):

Description	Common Stock		Cumulative Preferred Stock		Premiums and (Expenses) — Net
	Number of Shares	Par Value Amount	Number of Shares	Par Value Amount	
Balance, December 31, 1976	22,500,000	$56,250	2,374,199	$168,561	$256,091
Common Stock	4,076,428	10,191	—	—	71,338
Cumulative Preferred Stock, $8.32 Series J	—	—	500,000	50,000	(685)
Balance, December 31, 1977	26,576,428	66,441	2,874,199	218,561	326,744
Common Stock	6,200,830	15,502	—	—	102,732
Balance, December 31, 1978	32,777,258	$81,943	2,874,199	$218,561	$429,476

On January 22, 1979, the Company filed a registration statement with the Securities and Exchange Commission in connection with a proposed issue of 600,000 shares of Cumulative Preferred Stock, Series K, $100 par value.

NOTES TO FINANCIAL STATEMENTS

For the Years Ended December 31, 1978 and 1977

1. Summary of Significant Accounting Policies

(a) System of accounts — The accounting records of the Company are maintained in accordance with the uniform system of accounts prescribed by the Federal Energy Regulatory Commission (FERC) and used by the Arizona Corporation Commission (ACC).

(b) Plant and depreciation — Property is stated at original cost as defined for regulatory purposes. The cost of additions to utility plant and replacements of retirement units is capitalized. Replacements of minor items of property are charged to expense as incurred. In addition to direct costs, capitalized items include the present value of certain future lease payments (see Long-Term Debt), research and development expenditures pertaining to construction projects, indirect charges for engineering, supervision, transportation and similar costs, and an allowance for funds used during construction (See (d) below). Costs of depreciable units of plant retired are eliminated from plant accounts and such costs plus removal expenses less salvage are charged to accumulated depreciation. Contributions in aid of construction are credited to plant cost.

Depreciation is provided on a straight-line basis at rates authorized by the ACC annually, which are 2.85% to 4.16% for electric plant, 3.25% for gas plant, and 2.85% to 15.50% for common plant.

(c) Revenues and recognition of certain costs — Timing differences resulting from electric fuel adjustment clauses are reflected by deferring purchased power and fuel costs, or revenues, to be matched against revenues or costs, respectively, in subsequent periods. The estimated cost of gas purchased from the Company's supplier, but not billed to gas customers, is also deferred to be matched against revenues recorded in the subsequent period. Under its approved rate schedules, and subject to a hearing procedure applicable to purchased power and fuel adjustments in retail rates, the Company may pass through to its customers increases in purchased power and fuel costs, resale gas costs and specified taxes.

(d) Allowance for funds used during construction — In accordance with the regulatory accounting practice prescribed by FERC and the ACC, the Company capitalizes an allowance for the cost of funds used to finance its construction program ("AFC"). AFC, which does not represent current cash earnings, is defined as the net cost during the period of construction of borrowed funds used for construction, and a reasonable rate on funds obtained from other sources. The calculated amount is capitalized as a part of the cost of utility plant, resulting in a corresponding credit to other income for the portion of AFC attributable to equity funds and a credit to interest deductions for the portion of AFC attributable to borrowed funds.

AFC has been calculated using composite rates of 8% in 1977 and 9% in 1978, except for AFC related to project financing which was computed at the actual rate thereon. The increased rate in 1978 was accompanied by the change in income tax treatment described in Note (e) below. The resulting increase in net income was not material.

(e) Income taxes — The Company uses accelerated depreciation methods for income tax purposes. As prescribed by the ACC for rate making and accounting purposes, the Company began providing deferred income taxes for the difference between accelerated and straight-line tax depreciation of prop-

Note 1 (continued)

erty placed in service after January 1, 1977. Previously the difference was included currently in income. The effect of this change on the accompanying financial statements is not material. Income tax reduction arising from timing differences respecting certain other items of income and expense reported differently for income tax and financial reporting purposes and from allowable investment tax credits are reflected currently in income, in accordance with orders or practices of the ACC for rate making purposes.

Income tax reductions relating to the five-year amortization of emergency facilities in previous years have been deferred, with the deferred amount being restored to income over a twenty-year period.

Income taxes included in operating expenses for 1977 are reported before tax benefits (computed at the effective rate) due to interest expense applicable to construction work in progress; such benefits are included in the credit to interest deductions for the AFC attributable to borrowed funds. Starting January 1, 1978, such benefits are reflected in income taxes included in operating expenses.

(f) Investments in subsidiaries — Investments in subsidiaries are reported at equity.

(g) Employees' pension plan — The Company's policy is to accrue and fund the current and prior service costs of its pension plan. Prior service costs are amortized over a fifteen-year period.

(h) Research and development costs — The Company expenses research and development costs on a current basis, except that costs which may result in utility plant are deferred for subsequent inclusion in plant or to be written off if the applicable project is abandoned.

(i) The Company has presented its 1978 Statement of Changes in Financial Position, and restated its 1977 Statement, so as to reflect, as a non-fund item under Funds from Operations and as a reduction of Application of Funds — Capital Expenditures, only the equity portion of AFC. Previously, all of AFC was so reflected.

2. Project Financing

In 1977 the Company sold the construction work in progress for Unit 4 of its Cholla Plant to an unrelated corporation ("Owner"), which appointed the Company as its agent to complete construction of the Unit and agreed to resell it to the Company. The Company is unconditionally obligated to repurchase the Unit at or about the time of its completion (presently scheduled for May 31, 1981), and in no event later than July 31, 1981, for an amount equal to the Owner's cost of acquiring, completing and financing the Unit.

Financing is to be provided to the Owner by bank loans in two categories, the first consisting of up to $218,500,000 to be disbursed as construction progresses, to bear interest at 115% of prime and to become due on the date the Company is obligated to repurchase the Unit; such loans can then be refinanced by the Company (with interest thereon after a certain date increasing by ½%) for payment in five equal installments in 1981 ,1983 and 1984. Loans in the other category aggregate $41,500,000 of pollution control financing provided through a governmental authority to the Owner (with funds not yet required for the pollution control facilities included in Unit 4 being held in escrow for temporary investment, $26,901,000 being so held at December 31, 1978); these loans bear interest at 70% of prime and are due in 1987, but in effect will become due when the Company is obligated to repurchase Unit 4 unless assumed by the Company at that time (which assumption will require the issuance of the Company's first mortgage bonds in an amount equal to the balance of such pollution control loans.)

So long as the Owner remains the principal obligor thereon, both categories of loans will be secured by Unit 4 and the Company's repurchase obligation. The two categories are subject in varying degrees to cessation in funding or to acceleration, and interest on the pollution control loans is subject to increase, under certain conditions which did not exst at December 31, 1978. Pursuant to the loan documents, increases in Common Stock dividends are subject to certain restrictions related to current year earnings; for the year ended December 31, 1978 up to $75,894,000 could have been paid in Common Stock dividends compared to the $48,343,000 actually paid.

The Company includes costs of construction of Unit 4 in construction work in progress on its balance sheet. Net outstanding balances of the aforementioned bank loans, together with capitalized interest (11.9% for the year ended December 31, 1978) and related fees thereon, appear as a liability. In addition to the construction costs financed by the Owner through December 31, 1978, the Company incurred construction costs of approximately $5,000,000 which will be reimbursed by the Owner.

The Company has presented its 1978 Statement of Income, and restated its 1977 Statement of Income, so as to include the above interest and related fees in Interest on Long-Term Debt and Liability, offset by a like increase in Allowance for Borrowed Funds Used During Construction — Credit, in the amounts of $10,859,000 and $2,958,000 in 1978 and 1977, respectively. This change had no effect on net income.

3. Short-Term Borrowings and Compensating Balances

The Company had $107,000,000 in bank lines of credit, all unused at December 31, 1978 and 1977.

At December 31, 1978, $39,000,000 of the Company's commercial paper was outstanding at an effective rate of 10.65%.

Average aggregate short-term borrowings outstanding during 1978 and 1977 were $19,357,000 and $20,195,000, respectively; weighted daily average interest rates on such amounts were 8.80% and 6.59%, respectively. The maximum amount of short-term borrowings outstanding at any month end aggregated $49,000,000 in 1978 and $61,000,000 in 1977.

Compensating balances required at banks, but which were not legally restricted, were generally 10% of the line plus 5% (10% in some instances) of borrowings. Substantially all cash shown in the balance sheet is considered compensating balances.

4. Jointly-Owned Facilities

At December 31, 1978, the Company owned the following interests in jointly-owned electric generating and transmission facilities (dollars in thousands):

	Percent owned by Company	Plant in Service	Accumulated Depreciation	Net Plant in Service	Construction Work in Progress
Navajo Plant	14.0%	$110,361	$12,638	$ 97,723	$ 30
Four Corners Units 4 and 5	15.0	28,470	8,176	20,294	7,370
Palo Verde Nuclear Generating Station Units 1, 2 and 3	29.1	—	—	—	266,800
Certain transmission lines from the Navajo Plant (the Company's interest in which varies from 14% to 100%)	31.4	27,847	2,934	24,913	110
Total		$166,678	$23,748	$142,930	$274,310

The foregoing amounts represent the Company's interest in each facility. Financing for all such interests is provided by the Company. Its share of related operating and maintenance expenses is included in its corresponding operating expenses.

5. Income Tax Expense

Details of factors related to income taxes for the years ended December 31, 1978 and 1977 are as follows (see Note 1):

	1978	1977
	(Thousands of Dollars)	
Federal and state income tax expense at statutory rates	$61,161	$45,746
Reductions in taxes resulting from:		
Timing differences:		
Tax over book depreciation	(11,497)	(4,681)
Allowance for funds used during construction capitalized	(14,282)	(13,765)
Other — principally taxes, pensions and other items capitalized	(1,893)	(2,035)
Investment credit	(22,153)	(18,997)
Other items	—	(30)
Taxes currently payable	11,336	6,238
Deferred taxes included in expenses:		
Deferred	2,811	237
Restored	(210)	(210)
Total deferred	2,601	27
Total federal and state income taxes	$13,937	$ 6,265
Federal and state income taxes included in:		
Operating expenses	$13,917	$ 7,658
Other income	20	373
Allowance for borrowed funds used during construction — credit	—	(1,766)
Total	$13,937	$ 6,265
Taxes currently payable:		
Federal	$ 5,816	$ 2,216
State	5,520	4,022
Total	$11,336	$ 6,238

At December 31, 1978, the Company had approximately $19,000,000 of unused investment tax credit which could be carried forward through 1985, of which $6,500,000 has been recognized as a reduction of deferred taxes.

6. Pension Plan

The Company's pension plan covers virtually all employees. Contributions to the plan were $8,318,000 and $7,042,000 in 1978 and 1977, respectively. The liability for unfunded prior service costs at July 1, 1978 was $1,550,000, which is expected to be completely funded by 1981.

7. Commitments and Contingencies

The Company has collected approximately $8,400,000 of wholesale revenues during the period May 1976 through June 1978 pursuant to a rate filing being contested by certain customers in court. As related to operations through December 31, 1978, alleged tax liabilities to the Navajo Indian Tribe roughly estimated by the Company at $6,000,000, and $2,300,000 of alleged tax liabilities to the State of New Mexico, are being litigated by or on behalf of the Company. The alleged tax liabilities continue to accrue at an aggregate rate roughly estimated by the Company at $2,100,000 per quarter. The Company has collected approximately $3,000,000 of revenues subject to refund if ordered by FERC in a pending proceeding that relates to an increase in wholesale electric rates effective July 1, 1978. Based upon the opinion of its counsel, the Company believes that the ultimate resolution of the foregoing matters will not have a material effect on the accompanying financial statements.

The Company has signigficant purchase commitments in connection with its continuing construction program. Plant expenditures are currently estimated at $370,000,000 in 1979. Annual rentals under non-capitalized, non-cancellable leases were not material.

8. Lines of Business

Listed below is selected information relating to the Company's electric and gas operations as of and for the years ended December 31, 1978 and 1977:

	1978		1977	
	Electric	Gas	Electric	Gas
	(Thousands of Dollars)			
Operating revenues	$ 452,431	$109,786	$ 397,264	$ 96,420
Operating income before income taxes	141,043	11,574	109,154	10,352
Utility plant	2,152,937	135,667	1,753,809	135,511
Accumulated depreciation	335,533	52,027	292,969	48,865
Capital expenditures (excluding AFC — equity; see Note 1(i))	384,997	4,256	293,897	1,985

9. Selected Quarterly Financial Data (Unaudited)

Quarter	Operating Revenues	Operating Income	Net Income	Earnings for Common Stock	Earnings per Average Share of Common Stock
		(Thousands of Dollars)			
1978					
First	$128,025	$25,992	$19,265	$14,897	$0.56
Second	127,699	28,498	21,568	17,201	0.63
Third	164,835	49,304	41,394	37,025	1.27
Fourth	141,658	34,906	24,532	20,165	0.66
1977					
First	$109,676	$21,402	$15,342	$12,014	$0.53
Second	113,638	19,679	13,733	10,405	0.46
Third	157,240	42,845	32,813	29,220	1.30
Fourth	113,130	27,922	22,123	17,744	0.73

10. Replacement Cost Data (Unaudited)

The impact of the rate of inflation experienced in recent years and other factors have resulted in replacement costs of productive capacity that are significantly greater than the historical costs of such assets reported in the Company's financial statements. In compliance with reporting requirements, estimated replacement cost information will be disclosed in the Company's annual report to the Securities and Exchange Commission on Form 10-K.

ACCOUNTANTS' OPINION

Deloitte Haskins & Sells,
Certified Public Accountants
Phoenix, Arizona 85003

Arizona Public Service Company:

We have examined the balance sheets of Arizona Public Service Company as of December 31, 1978 and 1977 and the related statements of income, retained earnings and changes in financial position for the years then ended, and the schedules of capital stock and long-term debt. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, such financial statements and schedules present fairly the financial position of the company at December 31, 1978 and 1977 and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Deloitte Haskins & Sells

February 7, 1979

Additional legal matters

The step 3, five percent increase in retail electric rates that was put into effect on January 10, 1979 is subject to determination by the Arizona Corporation Commission that it was in accordance with the commission's August, 1977 order. A new format for adjusting retail rates for changes in the costs of generating fuel and purchased power has been adopted by the commission; while it may prove more cumbersome than the previous procedure, the company does not expect the change to be materially adverse to it.

Wholesale electric rate matters awaiting action by FERC include a 20 percent increase in effect for certain customers since July 1, 1978, as to which an agreement has apparently been reached, subject to FERC approval, that would lead to an immaterial amount of refunding by the company. A pending court contest of prior FERC rulings favorable to the company relates to approximately $8,400,000 of wholesale revenues recorded through December 31, 1978.

Certain rate-making and other aspects of the recently enacted federal energy legislation may have effects on the company's future operations that are not yet predictable by it, as may the federal wage and price standards.

The Four Corners and Navajo plants of the company are located on the Navajo Indian Reservation, as are certain of its transmission lines and all of its contracted coal sources. The Tribal Council has adopted three resolutions, two of which purport to impose taxes that, if valid, would cost the company an estimated $2,000,000 per quarter. The third resolution, which becomes effective only if and when certain action is taken by the Secretary of the Interior, purports to regulate sulphur emissions through a permit and fee system; if validly imposed, the fee would appear to be in an amount that would make it less costly (but nevertheless extremely expensive) to attempt to remove more sulphur dioxide from plant emissions than is required by federal and state law, so as to minimize the fee.

All three Navajo resolutions are being contested in court. Issues raised by the company pertain to the Tribe's governmental power to impose taxes and regulation, provisions in the plantsite leases whereby the Tribe agreed not to impose regulation or certain taxes, and preemption by the federal government of regulation over air pollution. These and related issues are pending in a suit brought by the company in the U.S. District Court for New Mexico. Certain of the same issues were decided adversely by the U.S. District Court of Arizona in a suit brought there by the operator of the Navajo Plant, and are on appeal.

The Tribe's attempt to regulate sulphur emissions, a related assertion of authority by the Secretary of the Interior and uncertainties as to whether the EPA will approve emission standards recently adopted by the State of New Mexico complicate the company's attempts to design pollution control equipment for the Four Corners plant to comply with the new state standards. The compliance effort is further complicated by a provision of the Clean Air Act Amendments of 1977 relating to "visibility"; implementing regulations, which have yet to be promulgated, may affect the Navajo and Cholla plants as well as the Four Corners plant.

The EPA has issued citations alleging violations of existing regulations in past operations of Four Corners Units 4 and 5, which the company disputes. It is possible that the EPA may seek fines from the participants in the Units of up to $25,000 per pollutant per day of alleged violation. More serious than that, however, would be the prospect of the company's inability to comply with the EPA regulations applicable to future operation of the Units pending completion of major installations of pollution control equipment; in that circumstance the company could be faced either with inability to maintain Unit operations in the intervening period or with fines in substantial amounts related to cost benefits of non-compliance, the company's share of which could be several million dollars per year.

In late February, the company argued its case against the New Mexico "electrical generation tax" before the U.S. Supreme Court on constitutional and other grounds. If that Court fails to overturn an adverse ruling by the New Mexico Supreme Court, the company's tax liability through December 31, 1978 would exceed by approximately $2,300,000 the amount provided therefor through collections from its customers.

Messrs. Snell & Wilmer, counsel to the company, believe that the company should ultimately prevail in nullifying the two Navajo Indian taxes and the New Mexico generation tax against it and defeating the Tribe's attempt to regulate it, but that there may be greater uncertainty as to the Navajo taxes against the company's coal suppliers. Based upon opinions of such counsel, the company believes that ultimate resolution of the foregoing matters will not have a material effect on the financial statements appearing herein.

BOARD OF DIRECTORS

***Ralph M. Bilby, 61,** Chairman of the Board, Phoenix, Arizona

***Karl Eller, 50,** President and Chief Executive Officer, Combined Communications Corporation (broadcasting, publishing and outdoor advertising), Phoenix, Arizona

***Del W. Fisher, 68,** Chairman of the Board, Fisher Contracting Co., Phoenix, Arizona

***William T. Garland, 62,** Chairman of the Board, Garland-Rhuart Development Corporation (land development), Sedona, Arizona

Leon Levy, 65, Honorary Chairman of the Board, First National Bank of Arizona, Tucson, Arizona

***Victor H. Lytle, 67,** Chartered Life Underwriter, Prescott, Arizona

Marvin R. Morrison, 55, Farmer and Cattle Feeder, Morrison Brothers Ranch, Higley, Arizona

James B. Rolle, Jr., 70, Senior Partner of the Law Firm of Rolle, Jones, Benton & Cole, Yuma, Arizona

Henry B. Sargent, Jr., 44, Financial Vice President of the Company, Phoenix, Arizona

Wilma W. Schwada, 52, civic leader, homemaker, Tempe, Arizona

Richard Snell, 48, Member of Snell & Wilmer (general counsel to the Company), Phoenix, Arizona

***Donald N. Soldwedel, 54,** President, Western Newspapers, Inc., Prescott, Arizona; Publisher and General Manager, Yuma Daily Sun, Yuma, Arizona

***Maurice R. Tanner, 57,** Chairman of the Board, President and Chief Executive Officer, The Tanner Companies (construction and materials supply), Phoenix, Arizona

***Keith L. Turley, 55,** President and Chief Executive Officer of the Company, Phoenix, Arizona

†Douglas J. Wall, 52, Member of the Law Firm of Mangum, Wall, Stoops and Warden, Flagstaff, Arizona

†Morrison F. Warren, 55, Director of Experimental Programs, College of Education, Arizona State University, Tempe, Arizona

†K. O. Wilbanks, 57, President, First National Bank of Farmington, Farmington, New Mexico

†Ben F. Williams, Jr., 49, Attorney at Law, Douglas, Arizona

Thomas G. Woods, Jr., 52, Executive Vice President of the Company, Phoenix, Arizona

DIRECTOR EMERITUS

E. Ray Cowden, President, Cowden Livestock Company, Phoenix, Arizona

*Member of Executive Committee
†Member of Audit Review Committee

OFFICERS

Ralph M. Bilby, 61, Chairman of the Board

D. L. Broussard, 58, Vice President, Research and Development

O. Mark De Michele, 45, Vice President, Corporate Relations

Karl Eller, 50, Chairman of the Executive Committee

Gerald J. Griffin, 58, Assistant Secretary

Howard F. Hersey, 50, Vice President, Gas Operations

Russell D. Hulse, 51, Vice President, Resources Planning

Jerry P. Human, 48, Vice President, Customer Services

Charles D. Jarman, 43, Vice President, Engineering and Construction

Lyman K. Mundth, 61, Vice President, Electric Operations

John C. Ogden, 33, Vice President, Administration and Economic Planning

Wm. T. Quinsler, 54, Secretary and Assistant Treasurer

Henry B. Sargent, Jr., 44, Financial Vice President

George H. Toler, 41, Treasurer

Keith L. Turley, 55, President and Chief Executive Officer

Edwin E. Van Brunt, Jr., 47, Vice President, Nuclear Project Management

Thomas G. Woods, Jr., 52, Executive Vice President, Operations

DIVISION MANAGERS

A. G. Anderson, 47, Western Division, Goodyear

Glen D. Daly, 50, Cochise Division, Douglas

Jack Duffy, 40, Navajo Division, Flagstaff

Dave Ellis, 40, Metropolitan Division, Phoenix

James C. Lauchner, 53, Pinal Division, Casa Grande

Guy W. Lunt, 45, Mountain Division, Globe

Don Roberts, 58, Yuma Division, Yuma

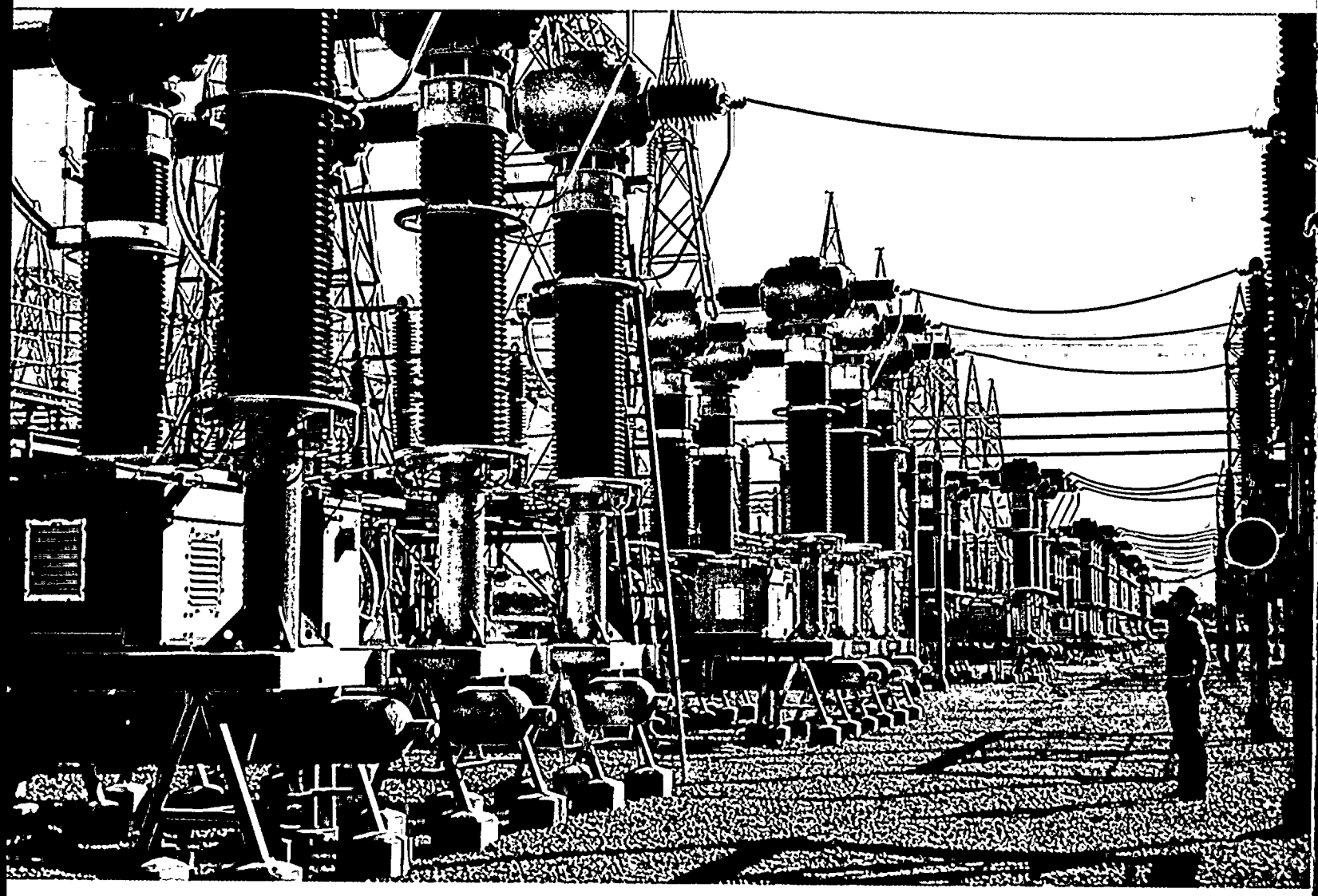
Jesse F. Thomas, 56, Yavapai Division, Prescott

(Numerals are ages at annual meeting date, April 19, 1979)

Arizona Public Service Company

1978 ANNUAL REPORT

"We see our role as more than that of energy supplier...
APS has a unique opportunity to help shape Arizona's future..."



APPENDIX 1B

ARIZONA NUCLEAR POWER PROJECT
PARTICIPATION AGREEMENT

Appendix 1B

Refer to Palo Verde Nuclear Generating Station Units 1, 2 and 3 (Docket Nos. STN 50-528/529/530) General Information, Construction Permit Application, Appendices 1A and 1B.

SECTION 2

GENERAL INFORMATION RESPECTING JOINT APPLICANT
EL PASO ELECTRIC COMPANY

(a) Name of joint applicant:

El Paso Electric Company

(b) Address of joint applicant:

Post Office Box 982
El Paso, Texas 79960

(c) Description of business of joint applicant:

El Paso Electric Company is engaged in the business of generating, transmitting and distributing electricity to 168,585 customers in its service area covering approximately 10,000 square miles in west Texas and south central New Mexico.

(d) (1) Not applicable.

(d) (2) Not applicable.

(d) (3) (i) State of incorporation and principal location:

El Paso Electric Company is a corporation organized and existing under and by virtue of the laws of the State of Texas. Its general offices are located at 303 North Oregon Street, El Paso, Texas.

(d) (3) (ii) Names, addresses and citizenship of directors and principal officers:

Directors of El Paso Electric Company

Name	Address
Evern R. Wall	303 North Oregon Street El Paso, Texas 79901

Name	Address
Paul Harvey	Hotel Paso Del Norte El Paso, Texas 79947
Robert E. Boney	Suite 316 1st National Bank Tower Las Cruces, New Mexico 88001
Tad R. Smith	Post Office Box 2800 El Paso, Texas 79999
George G. Matkin	Post Office Drawer 1072 El Paso, Texas 79912
Ben L. Ivey	9732 North Loop Road El Paso, Texas 79927
Robert H. Cutler	Post Office Box 9762 El Paso, Texas 79987
Josephina A. Salas-Porras	BI Language Services Coronado Towers 6006 North Mesa El Paso, Texas 79912
Leonard A. Goodman, Jr.	Post Office Box 117 El Paso, Texas 79941

Principal Officers of El Paso Electric Company

Evern R. Wall	President and Chief Executive Officer 303 North Oregon Street El Paso, Texas 79901
Rolland E. York	Senior Vice President 303 North Oregon Street El Paso Texas 79901
Billye E. Bostic	Senior Vice President 303 North Oregon Street El Paso, Texas 79901
James H. Jones	Vice President 201 North Water Street Las Cruces, New Mexico 88001

Harry I. Zimmer	Vice President 303 North Oregon Street El Paso, Texas 79901
Donald G. Isbell	Vice President 303 North Oregon Street El Paso, Texas 79901
Charles Mais	Administrative Vice President 303 North Oregon Street El Paso, Texas 79901
Ralph G. Crocker	Treasurer 303 North Oregon Street El Paso, Texas 79901
Mrs. Theta S. Fields	Secretary 303 North Oregon Street El Paso, Texas 79901
William J. Johnson	Controller 303 North Oregon Street El Paso, Texas 79901
Richard E. Farlow	Assistant Treasurer 303 North Oregon Street El Paso, Texas 79901
Robert L. Corbin	Assistant Secretary and Assistant Treasurer 303 North Oregon Street El Paso, Texas 79901
Miss Cecilia R. Shea	Assistant Secretary 303 North Oregon Street El Paso, Texas 79901
Richard C. Harris	Assistant Treasurer 90 Broad Street New York, New York 10004
Ralph G. Pellecchia	Assistant Secretary 90 Broad Street New York, New York 10004

Each of the directors and principal officers is a citizen of the United States of America.

(d) (3) (iii) El Paso Electric Company is not owned, controlled, or dominated by an alien, a foreign corporation or a foreign government.

(d) (4) El Paso Electric Company is not acting as agent or representative of another person in respect of this joint application.

(e) See Section 1 (e) hereof.

(f) In accordance with 10CFR50, Appendix C, a copy of Joint Applicant El Paso Electric Company's 1978 Financial Report is attached hereto as Appendix 2A.

(g) (Not used)

(h) Not applicable.

(i) The following listed regulatory agencies have jurisdiction over the rates and services of joint applicant El Paso Electric Company:

New Mexico Public Service Commission
Santa Fe, New Mexico 87501

Federal Energy Regulatory Commission
Washington, D.C. 20426

Public Utility Commission of Texas
7800 Shoal Creek Boulevard
Austin, Texas 78757

News publications which circulate in the area in which this facility is located are:

The Arizona Republic
120 East Van Buren
Phoenix, Arizona 85004

The Phoenix Gazette
120 East Van Buren
Phoenix, Arizona 85004

Buckeye Valley News
P. O. Box 217
Buckeye, Arizona 85326

News publications which circulate in El Paso Electric Company's service area include the following:

The El Paso Times
401 Mills Street
El Paso, Texas 79901

The El Paso Herald-Post
401 Mills Street
El Paso, Texas 79901

The Las Cruces Sun News
256 West Las Cruces Avenue
Las Cruces, New Mexico 88001

El Paso Journal
600 North Oregon Street
El Paso, Texas 79901

Van Horn Advocate
Van Horn, Texas 79855

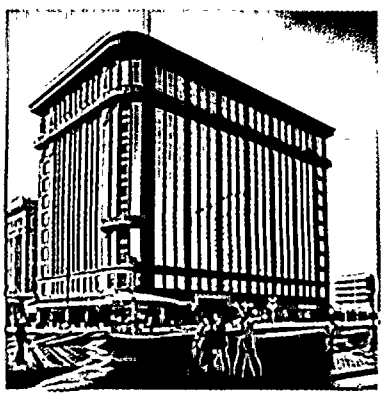
Alamogordo Daily News
24th & Eudora Street
Alamogordo, New Mexico 88310

(j) Not applicable.

APPENDIX 2A

EL PASO ELECTRIC COMPANY 1978 ANNUAL REPORT

EL PASO ELECTRIC COMPANY 1978 ANNUAL REPORT



The Mills Building
is the new headquarters of El Paso Electric. The building was the largest monolithic concrete structure in the United States when completed in 1915 and has been granted a marker from the Texas Historical Commission. Exteriors of the landmark building were modernized in 1974 and the interiors were refurbished by El Paso Electric in 1978 and 1979.

Highlights

	At December 31 1978	1977
Operating Revenues (000)	$ 136,556	$ 112,339
Operating Expenses (000)	$ 116,107	$ 95,002
Net Income (000)	$ 16,024	$ 11,422
Earnings per share	$ 1.30	$ 1.11
Dividends per share (Common)	$ 1.02	$ .99
Book Value per share	$ 10.01	$ 9.33
Common Shares Outstanding	11,191,371	8,536,818
Number of Common Shareholders	25,633	19,156
Number of Customers	168,009	159,924
Number of Employees	908	838
Peak Load	690,000 KW	657,000 KW
Net Generating Capacity	982,000 KW	982,000 KW
Average Residential Use	6,153 KWH	6,261 KWH
Fuel Expense (000)	$ 73,447	$ 59,442
Energy Sales (MWH)	3,320,649	3,242,724
Electric Plant (000)	$ 438,085	$ 338,598

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Dividend Reinvestment

A Dividend Reinvestment and Stock Purchase Plan is available to holders of Common Stock. This Plan is a convenient method of investing dividends and optional cash payments in new shares without payment of issuing expenses. An enrollment card may be obtained from the Company Secretary.

About the Cover . . .
Linemen from the Mesilla Valley Division repair an insulator on a transmission line Northeast of Las Cruces with the majestic Organ Mountains in the background.

Figures appearing in this report are presented as general information and not in connection with any sale or offer to sell or solicitation of any offer to buy any securities nor are they intended as a representation by the Company of the value of its securities.

Letter to the Shareholders

The efforts of the men and women of El Paso Electric Company were rewarded by improved financial results in 1978. Earnings per share of common stock increased to $1.30 in 1978 from $1.11 in 1977 and $1.29 in 1976. The past year's earnings indicate a return to the Company's historical earnings pattern.

Operating revenues for the year rose to $136,556,000 from $112,339,000 in 1977. Operating expenses increased to $116,107,000 in 1978 from $95,002,000 the previous year.

Quarterly dividends on Company Common Stock were increased from 25 to 26 cents per share during 1978, bringing the total for the year to $1.02 per share.

Much of the financial improvement is a result of the increased rates approved by regulatory bodies in Texas effective in late 1977, and New Mexico early in 1978.

Effective December, 1978, the Public Utility Commission of Texas (TPUC) authorized a rate increase in the Company's Texas service territory designed to provide approximately $8.6 million in annual revenues during 1979. The TPUC authorized the Company to include $22 million of construction work in progress (CWIP) on the Palo Verde Nuclear Generating Station in rate base. The order demonstrates an awareness by the TPUC that dividend payments and interest on long-term construction costs must be taken into account as construction programs and their costs grow.

The criteria upon which the TPUC based its final decision was the Company's need to maintain its financial integrity and to continue providing a fair return to investors.

In June, 1978, a rate case was filed with the New Mexico Public Service Commission, and an updated case was filed in December, 1978. The new request was necessary because of decline in earnings from New Mexico operations, inflationary pressures, and the delay in New Mexico in hearing the original case.

In order to provide the basic plant facilities that recent projections indicate are required to meet load growth, and to meet the ever increasing costs of doing business, it will be necessary to seek additional rate relief during 1979.

Fuel continues to be the Company's largest expense item. Total fuel expenses increased from $59 million in 1977 to $73 million last year, a 24% increase representing 63% of the Company's operating expenses. While the National Energy Act may expand domestic supplies somewhat, trends indicate that the cost of petroleum fuels used to generate electricity will continue to rise sharply.

Prices for coal and uranium, on the other hand, are expected to increase at a slower rate as a result of their domestic abundance and relatively limited use by other industry. It is clear that the unstable conditions relative to petroleum fuels and recent federal legislation will cause much of the electric utility industry to shift from oil and natural gas to coal and uranium in the years ahead.

To finance the Company's $87 million construction program during 1978, the Company sold debt and equity securities providing proceeds of approximately $49 million. During 1979 the Company anticipates construction expenditures of approximately $129 million.

During the past few years and for the foreseeable future, priorities of El Paso Electric, like those of its sister utilities in other growth areas, will continue to change. New and more complex concerns have been added since the early 1970's. Management must accommodate itself to rapid changes in national and international energy supplies

and reconcile often contradictory local, state and federal regulations. It must also communicate to an often bewildered public the need for regularly increasing rates and dramatically escalating capital investment needs to carry out its construction program.

Among the major new regulatory directives affecting your Company are the National Energy Act and the President's price and wage guidelines.

Although it is much too soon to know totally how the new energy legislation will affect the Company's operations, it is important to know that your Company has already made many of the changes which are now being required by law.

One of the goals of the National Energy Act is to reduce petroleum imports and to replace oil and natural gas with alternative domestic fuels such as coal and uranium. The Company in 1965 recognized the importance of developing new fuel supplies and began changing from its traditional gas and oil-fueled generation by participating in the coal-burning Four Corners Power Station near Farmington, New Mexico. Later in 1973 the Company made additional decisions to reduce its reliance on gas and oil by participating in the Palo Verde Nuclear Generating Station currently under construction 50 miles west of Phoenix, Arizona.

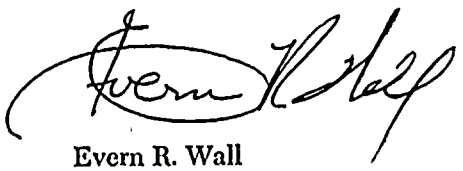
There are some that find fault with the need to proceed with nuclear power, but we are more concerned with those who would be seriously affected if your Company, and others in the industry, did not have the necessary electric energy to meet their needs and would then be faced with some form of power rationing.

The Company intends to cooperate with the President's policies pertaining to wage increases and hopefully the federal government's economic policy will begin to slow inflation — the nation's most serious economic problem. However, your management believes additional standards are necessary for the electric utility industry and that the Administration must consider the special problems of the industry in meeting the price guidelines. Because electric utilities are already heavily regulated and are faced with mounting construction costs to meet increased demand, they will encounter special difficulties in complying with the price guidelines. The price guidelines must be flexible enough to permit restoration of a utility's profitability to a level sufficient to allow the financing of its construction program while meeting the requirements of the National Energy Act. The National Energy Act's requirements are expected to impose additional costs on utilities which must be reflected in increased prices for electricity.

The management of your Company is keenly aware of the problems created by the various lag times imposed by regulatory authorities, and hopefully remedies will be forthcoming. Hearings should be prompt and scheduled while financial and operating information are still fresh and meaningful. Otherwise, the Company is forced to seek additional rate increases at an unnecessarily accelerated rate.

Each day brings new signs of growth to the Company's service area, in terms of more industries, business, jobs, and residents. Long-range planning efforts will enable your Company to support this sustained growth at economically competitive rates. The Company remains committed to furnish high quality service to all its customers at the lowest rates consistent with the need to provide a reasonable return to shareholders.

Meeting this challenge will require the continued active participation of our directors and employees and the support of investors and friends. For the help of all these in the past, I extend my deepest thanks.



Evern R. Wall
President and Chief Executive Officer

Service Area and Operations

New and expanding industries continued in 1978 to find the El Paso area an excellent place in which to locate and work, bringing a harvest of economic benefits to the El Paso Electric Company service area. Known as the "Sun City" long before the rest of the nation began focusing on the economic desirability of the Sunbelt, El Paso is among the 10 fastest growing metropolitan areas in the United States. The Bureau of Census study which established the city's expansion rate ranked El Paso as 32nd among the nation's 100 largest cities. By the year 2000, according to estimates of the City's Department of Planning, Research and Development, the population will have climbed approximately 50 percent, from the present 400,000 to 620,000.

Another record year was experienced by the El Paso construction industry, as reflected in building permits, which totaled $219.1 million, a 2 percent increase over the record-setting level of $214.8 million in 1977. Residential construction accounted for 58.2 percent of the total.

Other growth indicators for El Paso show that from 1972 through 1977 manufacturing payroll was up 14.9 percent to $256,691,000. Total employment increased 4.3 percent during 1978.

Because of its combination of location, labor market and favorable climate, the area is developing a strong industrial base to match its traditional roles as a center of agriculture, military operations, transportation and tourism.

Apparel manufacturing, the area's leading industry, is followed closely by electronics assembly. Metals smelting and refining, petroleum refining, food processing and cement manufacturing are other major cornerstones of the economy.

The economic impact of new industry locating in El Paso and vicinity over the past two years is estimated by the El Paso Industrial Development Corporation at more than $500 million. Among new or expanding firms in El Paso were GTE Lenkurt, Inc., Collins Radio (a division of Rockwell International), Westinghouse Corporation, Allen-Bradley Corporation, Victor United Inc., Marion Hospital Supply, Indiana General Motors Products, Acme Boot Company, Robertshaw Controls Corporation and Southern Electric Company.

Corporations operating twin plants in El Paso and neighboring Ciudad Juarez, Mexico, under incentives provided by both nations are widely recognized names in American industry. Among participants are General Motors Corporation, General Electric Corporation and Chrysler Corporation.

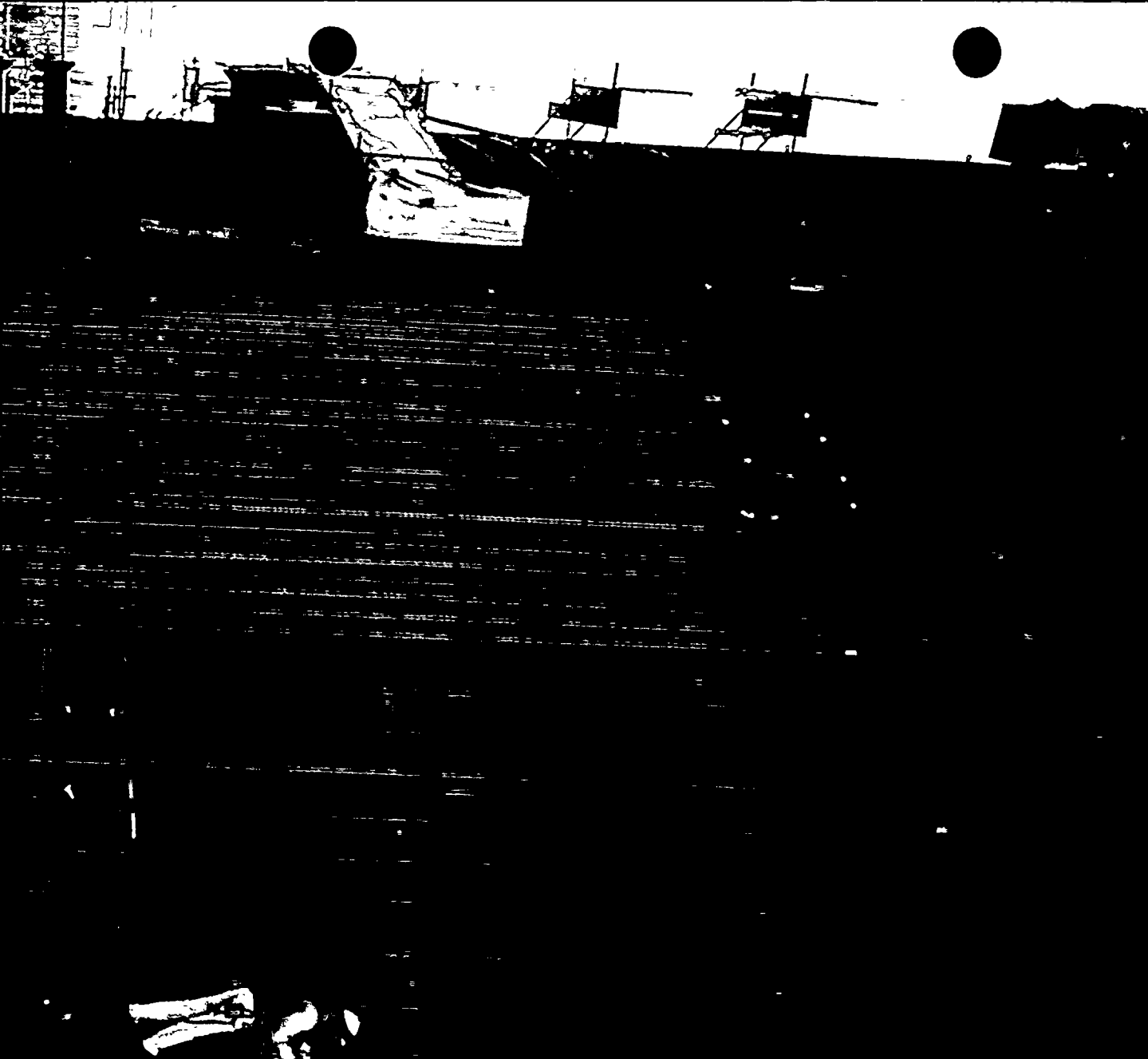
Ciudad Juarez, a city of more than 700,000 and fourth largest in Mexico, is an increasingly important funnel for tourists and manufactured goods destined for the interior of Mexico.

Because of El Paso's growing importance as an inland port of entry, an application to establish a Foreign Trade Zone in the City will be filed with the U. S. Commerce Department in the near future.

Military establishments continue to be major employers in the Company's service area. Among them Fort Bliss Army Air Defense Center, William Beaumont Army Medical Center, White Sands Missile Range and Holloman Air Force Base are the principal installations.

The Company's Mesilla Valley Division (New Mexico) serves approximately 32,600 customers. White Sands Missile Range, the nation's largest land-based missile operation,

Construction workers weld steel casing on the containment vessel at the Palo Verde Nuclear Generating Station.



Holloman Air Force Base, New Mexico State University, and the National Aeronautics and Space Administration (NASA) Test Facility are served by the Mesilla Valley Division.

A major new NASA facility 15 miles east of Las Cruces, New Mexico, the Tracking Data Relay Satellite System, is expected to become operational by late 1979 or early 1980. At a cost of over $700 million, the facility is being built and operated by Western Union. The completed project will employ two satellites matched with the earth's rotation and a terminal station at the White Sands facility, making it the world-wide center of all NASA's ground-to-space communications.

Building activity in Las Cruces reached an all time high for the second year in a row. Building permit totals in Las Cruces in 1978 were $38,373,076, up 53 percent over 1977.

Revenues Reflect Heat Wave, Population and Increased Sales

Major challenges and opportunities present themselves to El Paso Electric in providing electricity for increased demands from present and new business and industry, public facilities and for the additional population from which the growing work force is drawn.

Total operating revenues for El Paso Electric reached $136.5 million in 1978, up $24.2 million or 21.6 percent over 1977. The increase resulted from additional air conditioning use during last summer's extended hot weather, increased fuel revenues because of higher fuel costs, new customers and rate increases which were in effect for most of 1978. Total operating expenses increased $21.1 million or 22.2 percent for the year. Increased fuel costs accounted for more than half of the increase with the remainder principally caused by inflationary pressures on wages, materials and other costs.

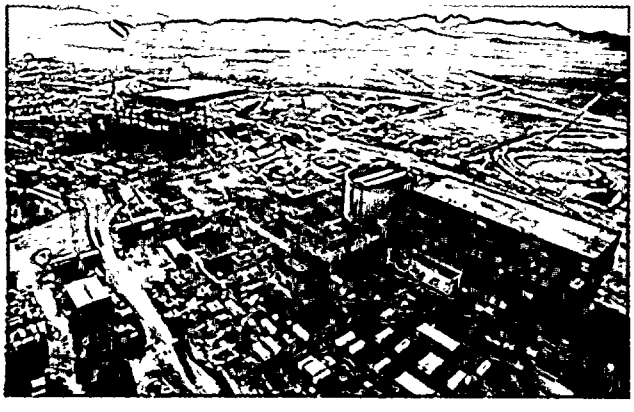
The Company was serving approximately 168,000 customers at the end of 1978, an increase of 5 percent over 1977; of that number, 135,400 were in Texas and 32,600 were in New Mexico.

Total system sales climbed to 3,320,649 megawatt-hours (MWH), a 2.4 percent increase over 1977.

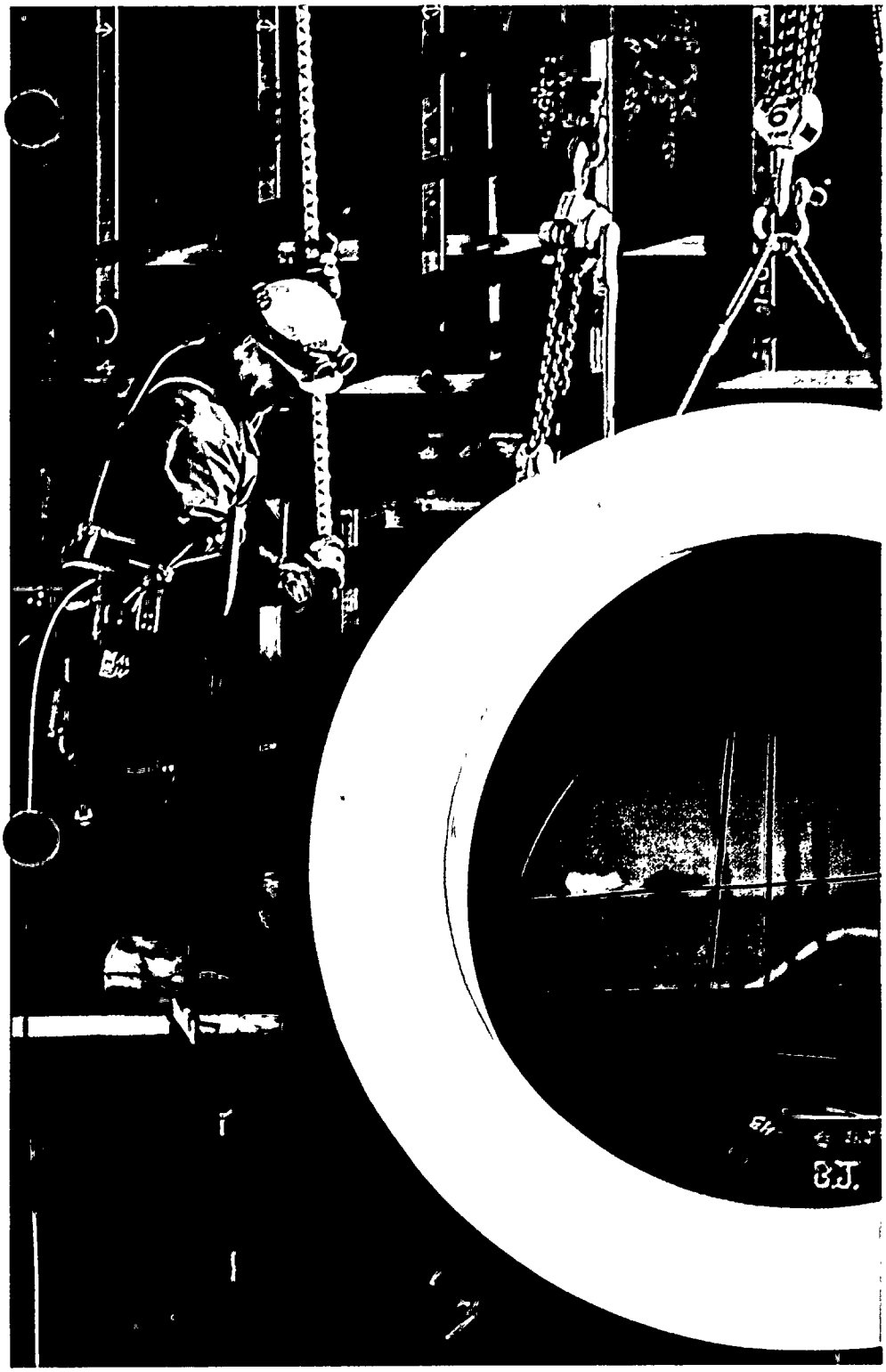
The commercial and industrial customer category, including schools, hospitals and other public facilities, as well as stores and offices, accounted for 1,563,580 MWH, up 3 percent from 1977. Residential customers accounted for 908,000 MWH, 4 percent more than last year. The average residential customer used 6,153 KWH, a 1.7 percent decrease. The average cost per KWH for residential customers was 4.9 cents.

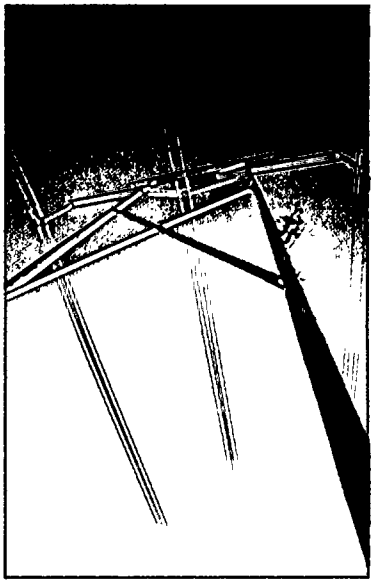
The highest peak load in El Paso Electric history, 690,000 kilowatts (KW), was experienced July 18 during a record-setting summer heat wave. The previous record of 677,000 KW, set in 1976, was surpassed twice during June's 14-day string of 100 degree-plus days in West Texas and Southern New Mexico.

The trend of increased electricity consumption serves to confirm the Company's estimate of future generating needs in which the use of nuclear energy and coal is planned for additional base load requirements with continued use of some natural gas and oil for peak demand periods.



The Palo Verde Nuclear Generating Station is now under construction in central Arizona. When completed in 1986 it will be the largest nuclear generating station in the United States.





Cruz Talavera, apprentice lineman, is representative of those El Paso Electric employees who maintain distribution lines.

Towering structures carrying 345,000 volt lines connect El Paso Electric with member utilities in the Western Systems Coordinating Council to insure customers of electric reliability.

The Company's continuous construction program provides assurance that peak electricity demands in the future will be met.

Fuel Shortage and Expense Push Need for Nuclear Generation

Of the Company's 982 megawatts of installed generating capacity, 870 megawatts (498 megawatts at the Newman Power Station in Northeast El Paso and 372 megawatts at Rio Grande Power Station in a segment of New Mexico near downtown El Paso) will continue to be affected by the increasing cost and regulation of oil and natural gas. The remaining 112 megawatts represent the Company's 7 percent entitlement from Units 4 and 5 of the coal-fueled Four Corners Power Station, near Farmington, New Mexico.

At the Palo Verde Nuclear Generating Station, 50 miles west of Phoenix, Arizona, a total of 600 megawatts of base load generating capacity, representing El Paso Electric's 15.8 percent interest in three nuclear generating units, will be added as these units are placed in service. Projected completion dates are 1982, 1984 and 1986, respectively. The Palo Verde Project, in which four other Southwest utilities share costs and generation entitlements with the Company, remains on schedule.

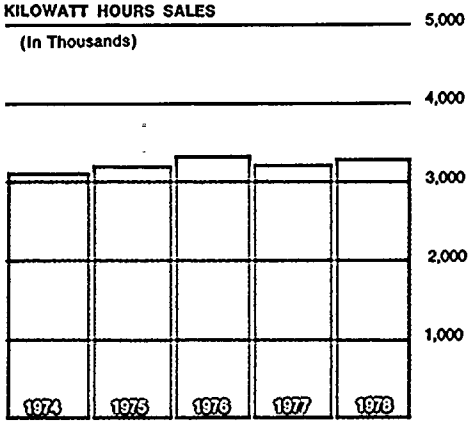
As of December 31, 1978, the Company had expended approximately $136 million on the Palo Verde Project, including Allowance for Funds Used During Construction (AFUDC). Of that amount, $77 million was spent in 1978, and the Company expects to spend $110 million in 1979. Company expenditures for Palo Verde's generation and related transmission facilities are estimated at approximately $629 million for the period 1979 through 1986. Nuclear fuel costs will aggregate approximately $62 million during the same time span.

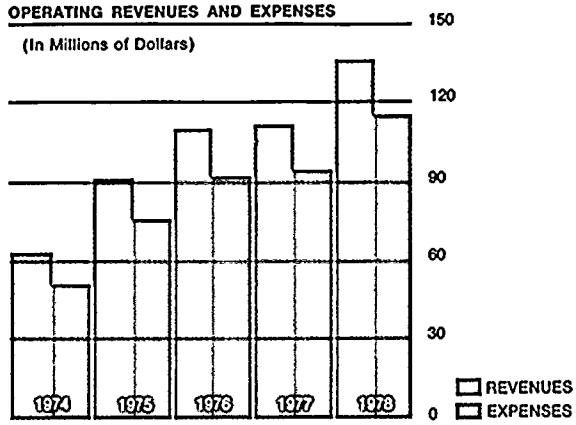
At year end, construction on Palo Verde Unit 1, first of the three units now under construction, was 32.2 percent complete. By year's end the Palo Verde Project had reached an overall 22.3 percent of completion. Contained in that statistic is a dramatic episode in the history of American utility engineering. The largest single shipment of nuclear components ever transported to a U.S. power plant site was completed November 22, 1978, when the reactor vessel and two steam generators for Unit 1 ended a journey of approximately 5,500 miles. The 2,000-ton shipment was barged from the fabricator in Chattanooga, Tennessee, down the Mississippi River, through the Panama Canal and up Mexico's Bay of California to a point about 200 miles south of the site. The remainder of the journey was made overland through Mexico and Arizona on specially-built trailers.

Looking toward more distant energy needs and recognizing the long lead time required in complying with the growing number of government regulations, the Company and 10 other Western energy suppliers in 1978 filed a joint application with the Nuclear Regulatory Commission for construction of two additional Palo Verde units. Preliminary public hearings before the Nuclear Regulatory Commission on Units 4 and 5, in which the Company's proposed interest is 4 percent, were held in 1978.

The Palo Verde Station will soon provide a substantial percentage of the Company's total customer requirements and will mark the next step in the transition from fossil fuels to alternative generating sources. The initial step was taken in the 1960's when the Company began using coal-fueled generation at the Four Corners power station.

Uranium supplies sufficient to last through 2001 for the first three Palo Verde units are





already under contract. The participants have sought further assurance of a uranium supply by acquiring a 50 percent interest in uranium mining claims and leases covering approximately 60,000 acres in Wyoming.

To provide power generation for peak load demand, the Company is constructing a 73 MW combustion turbine peaking unit in El Paso. Completion is expected in mid-1980.

To maintain a balanced use of available fuels in the light of increasing expense and scarcity of oil and natural gas, the Company is planning additional coal-fueled base load generation in the Bisti Basin of northwest New Mexico.

The use of coal, however, poses additional problems in complying with federal and state environmental requirements. The Four Corners Station is being required to install air quality control equipment by 1982, at an estimated cost to the Company of $15.7 million, which is more than its original investment in the generating facilities.

New Transmission Lines, Computer Enhance Power Delivery

In September, a new 200-mile, 345 KV transmission line from Newman Power Station to Greenlee, Arizona was energized, strengthening the El Paso Electric system links with utilities in New Mexico, Arizona and other nearby states and providing an additional path to the Four Corners Station. The line also provides additional capacity for economy energy interchange with these utilities.

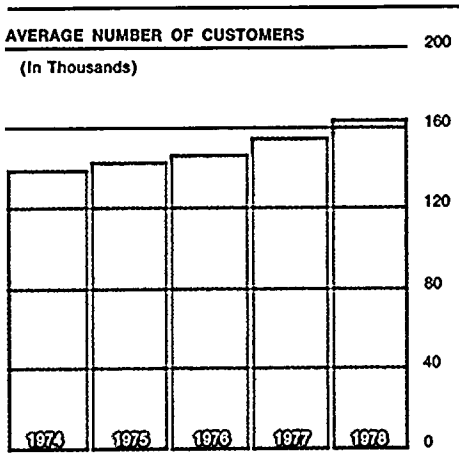
The Company and five other Southwestern utilities have taken preliminary steps toward development of an interconnected power pool. Under the proposal, power exchange agreements would allow joint planning of future generating and transmission facilities possibly reducing future capital expenditures and providing a number of other benefits to customers. The proposed "Cactus Pool" could be in operation by mid-1979, depending upon final approval by the utilities and regulatory authorities.

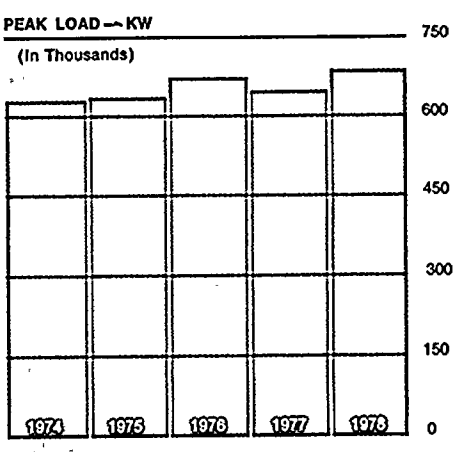
By the end of 1978 the Company's power delivery network for transmission and distribution in its two-state service area totaled 4,758 line pole miles, a 4.2 percent increase from last year.

Late in 1978, a Leeds and Northrup 5400 digital computer system was installed and became operational in the Company's System Operations Department. The advanced computer system combined the supervisory control and data acquisition facility and the automatic dispatching facility into a modern energy management system. The new system will result in substantial savings by automatically controlling generating units so that available fuels are used in the most economical way in meeting electricity demands at any particular time.

Debt, Equity Finance Construction — Present and Future

The Company's construction program reached $87 million in 1978 and the resulting cash requirements gave rise to the sales of several new security issues. In February and August the Company sold 1,500,000 and 1,000,000 shares of Common Stock. In July the Company sold $9,000,000 principal amount of 6¾% First Mortgage Bonds, and in October and November sold 120,000 and 20,000 shares of $8.44 dividend Preferred Stock. Aggregate net proceeds of $49,341,000 were received from these new issues.





The Company's Common Stock continues to be traded in the over-the-counter market and the bid prices during 1978 ranged from a low of 9⅞ to a high of 11⅞. A book value at December 31, 1978 of $10.01 per share indicated the Company's ability to sell common stock at or above book value, a record the Company is very proud of.

During the fourth quarter of 1978 the Company paid its 128th consecutive dividend since 1947 on its common stock and during 1978 increased this quarterly dividend from 25¢ to 26¢ per share.

Rate Relief Granted; New Request Filed

In order to recover increased costs of operation, to help finance additional capital expenditures and to maintain an adequate level of earnings, the Company filed on June 30, 1978, a rate increase totaling $12.9 million in its Texas service area. On November 9, the Public Utility Commission of Texas, after comprehensive public hearings, granted the Company a rate increase (effective December 6) providing approximately $8.6 million in annual revenues from its retail customers in Texas, an increase of approximately 8 percent. The Commission allowed the Company to include in rate base approximately $22 million of construction work in progress (CWIP) on the Palo Verde Nuclear Generating Station. The increase was calculated for an overall return on rate base of 10.1 percent and a return on common equity of 14.2 percent.

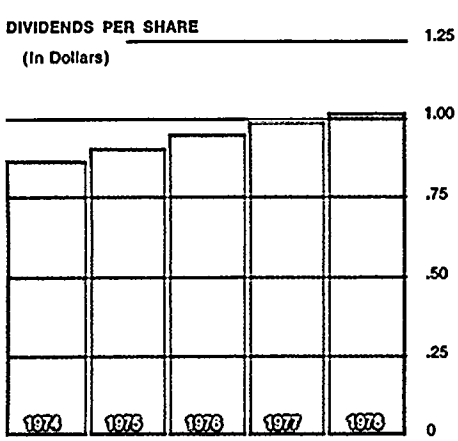
In its final order in November the Commission again certified the Company's full participation in the Palo Verde Project, finding it "necessary for the service, accommodation, convenience and safety of the public."

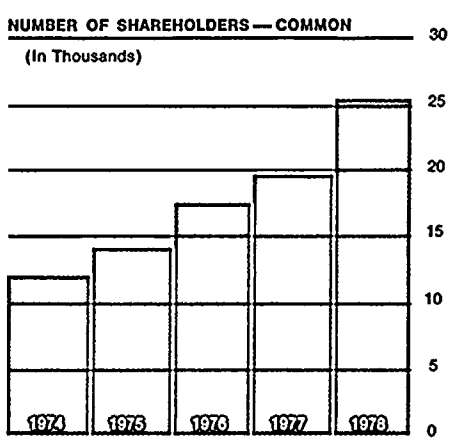
There has been much interest at the state level in possible rate reforms aimed at sending consumers the proper pricing signals regarding energy usage patterns. In response, the Public Utility Commission of Texas conducted three weeks of hearings regarding future rate structures and cost allocation methods in keeping with contemporary economic and regulatory conditions. The state's utilities, including El Paso Electric, presented testimony during these proceedings along with business, industry and consumer groups. The final report of the Commission to the Texas legislature recommended further examination of time differentiated rates while opposing lifeline rates. The report also included recommendations that the legislature consider the appropriateness of direct assistance to low income utility customers and that utilities review marginal cost pricing methodologies.

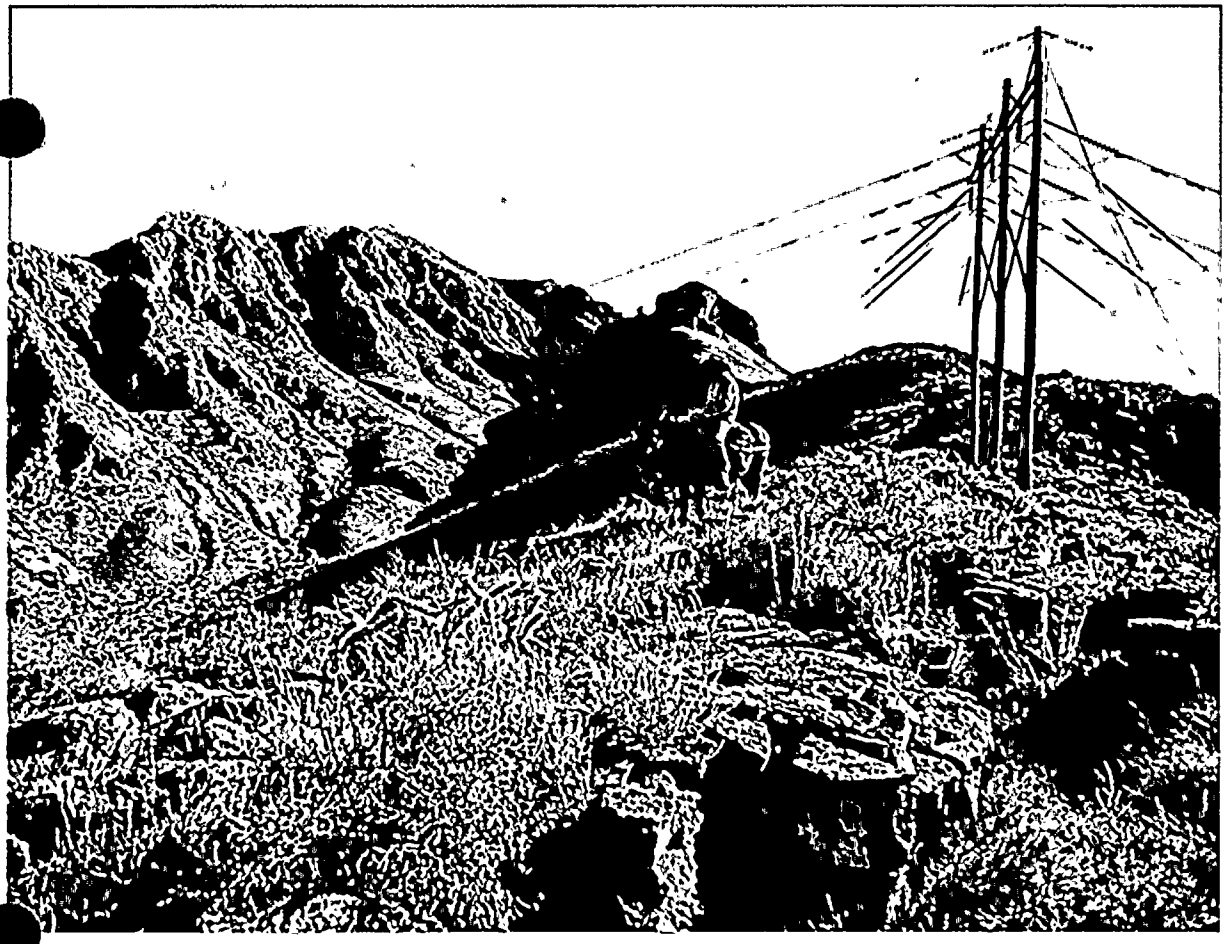
The Company also filed a rate increase application on June 30 , 1978, with the New Mexico Public Service Commission, which application was updated in December to a total rate increase of approximately $7 million. A final order is expected in May, 1979.

The Company filed an increase application with the Federal Energy Regulatory Commission for its wholesale customers. Hearings were held in the last quarter of 1978 and early 1979. A decision is expected in mid-1979.

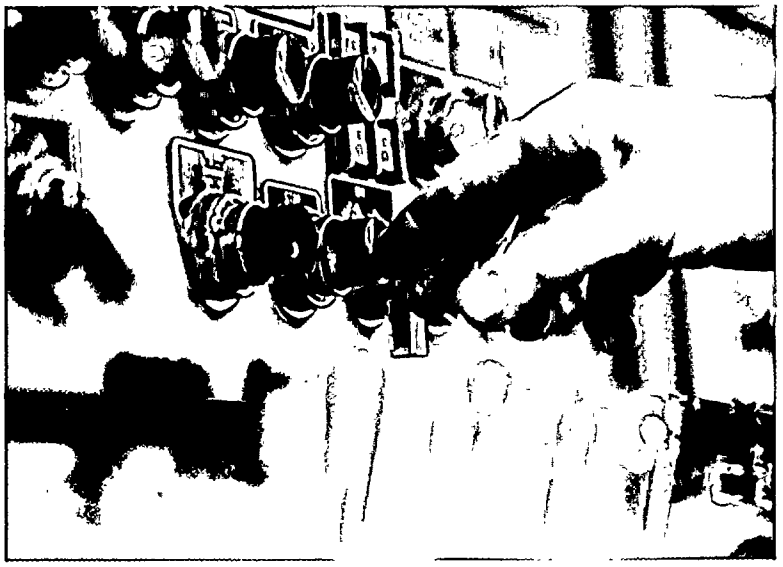
Rates must be sufficient to pay all costs, including a fair rate of return to investors, if electric service is to be maintained at an adequate and reliable level. Sensitive to the social and economic issues involved in the cost of essential electric service for persons with low or fixed incomes, the Company maintains ongoing communications with public and private authorities in the search for ways to help these population segments while,





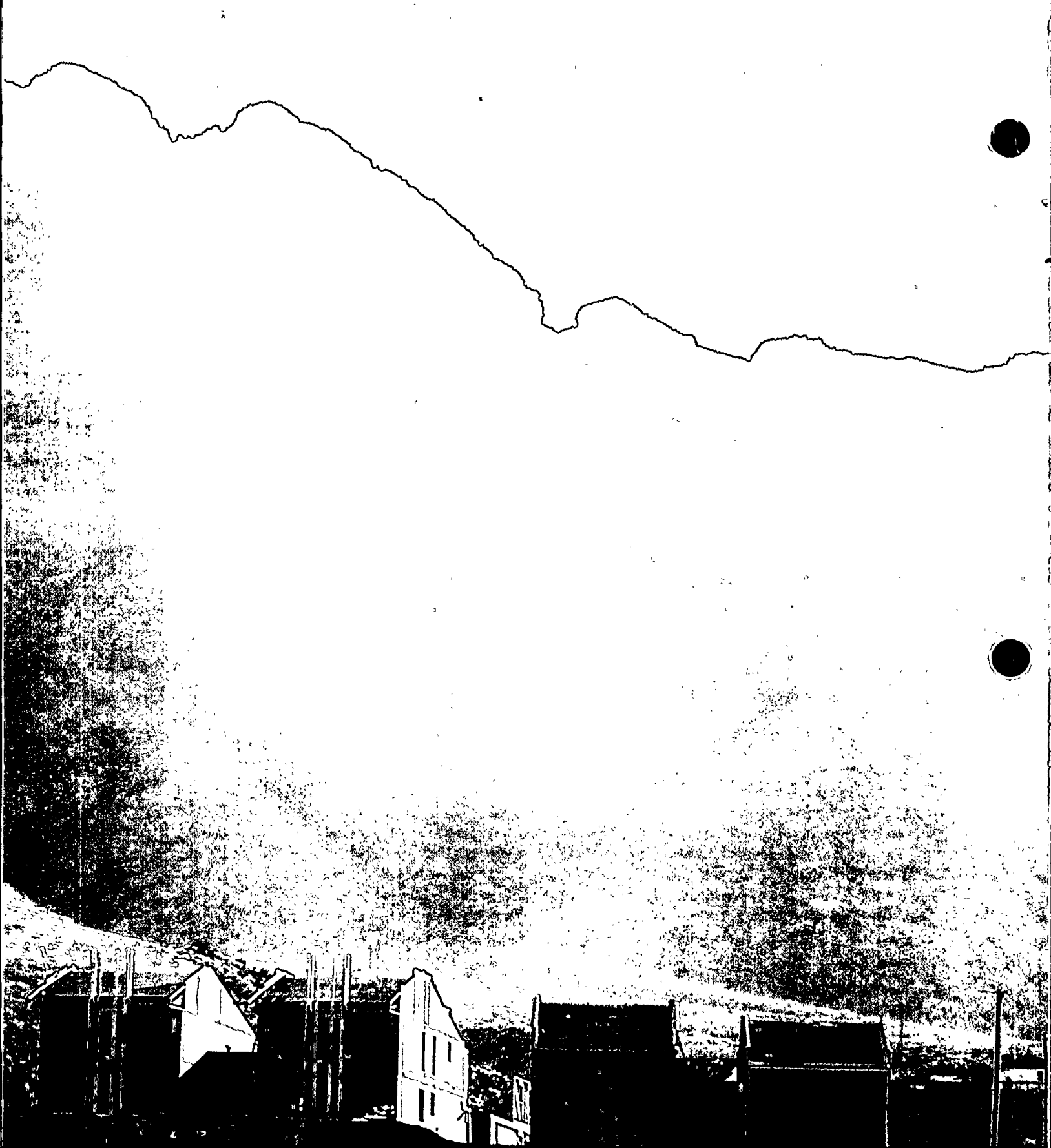


Interconnecting transmission lines between West El Paso and East El Paso traverse the summits of the rugged Franklin Mountains.



Controls of the complex machinery at the Newman Power Plant are located in a central console and watched by experienced operators.

A veteran troubleshooter keeps the current flowing under all climatic conditions.



at the same time, avoiding an unfair burden on the rest of the customers.

Fuel Costs Continue To Rise

Although fuel used to generate electricity continued to be the Company's largest single expense item in 1978, the cost was recovered by fuel cost adjustment provisions in all rate tariffs. Under these provisions, the Company collects for fuel costs to pay its fuel suppliers, adjusting the fuel portion of the electric bill in accordance with the costs.

Total fuel costs increased by $14,005,000 or 24 percent in 1978, to $73,447,000.

Until 1972 the Company was almost exclusively dependent on natural gas to fuel its boilers. Since that time, however, the Company has experienced curtailments of gas, increasing its use of fuel oil.

In 1978 the Company's fuel mix consisted of 85 percent natural gas, 3 percent oil and 12 percent coal. Natural gas for the Company's principal gas and gas/oil generating units is provided under long term contracts with the Company's major fuel supplier, El Paso Natural Gas Company. The Company burned 3,200 billion cubic feet of natural gas in 1978, a portion of which was supplied because of misallocations by its supplier in prior years.

The average price of fuel oil, the most expensive fuel used by the Company, decreased 1.5 percent in 1978 to $2.60 per million BTU from $2.64 per million BTU in 1977. The average price of interstate natural gas increased from $1.07 per million BTU in 1977 to $1.36 per million BTU in 1978, an increase of 27.1 percent, and the average price of intrastate natural gas increased 4.9 percent from $2.03 to $2.13 per million BTU. The price of natural gas is expected to continue escalating in 1979. The price of coal, the least expensive fuel presently used by the Company, increased 18.8 percent over 1977 levels from an average of $0.32 per million BTU to $0.38.

The outlook for continuing use of petroleum as a boiler fuel is bleak. Continuing price increases and prospective shortages are a constant source of uncertainty and concern. Moreover, state and federal regulations will, in certain instances, prohibit the continued use of natural gas as a boiler fuel, requiring conversion to nuclear and coal fuels.

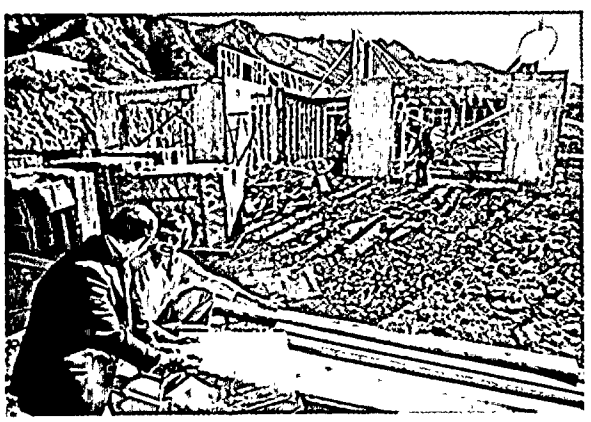
Although the Company presently anticipates sufficient petroleum fuel supplies to support its existing generating facilities, the future course is clearly to lessen reliance on petroleum fuels and to quickly move toward coal and nuclear power alternatives for base load purposes.

Management is aware of its heavy responsibility for continuing programs to assure an adequate and reliable electric power supply for the families and businesses in the Company's service area, realizing that without adequate research and planning this goal cannot be achieved.

Company Is Active In Alternate Energy Research

To assure an adequate power supply as reliance on fossil fuels dwindles in the years to come, the Company is actively involved in the investigation of alternate energy sources.

The Company is a member of the Texas Atomic Energy Research Foundation (TAERF), composed of 10 Texas power companies. Since 1957, the foundation has sponsored research for control of nuclear fusion reactions for the production of electric



The early morning sun illuminates new construction at the foot of Mt. Franklin.

A Company representative and building contractor discuss energy efficiency in new construction on the scene.

power. In 1978, researchers at the University of Texas at Austin invented a novel power generator, called a "compulsator", which is capable of producing the short, intense bursts of energy needed in fusion experiments. Evern R. Wall, President of El Paso Electric, was elected vice president of TAERF in May, 1978.

While solar energy for heating and cooling structures and for heating water has been demonstrated to be practicable, although only marginally cost effective, its use in generating electricity in significant quantities or at realistic prices has yet to be shown.

Nevertheless, the Company is developing experimental rates for residential customers who use supplemental solar energy systems and is actively participating in several demonstration projects.

Solar energy projects at the University of Texas at El Paso, New Mexico State University and elsewhere have attracted Company support.

The Department of Energy has approved the first phase of a solar project to provide a small portion of the station service needed at the Company's Newman Power Station. The 20 KW photovoltaic flat panel power system should supply direct current for up to 80 percent of the required energy needed to operate the computer controlling Unit 4 at the station. The project is expected to be operational by 1980.

The Company's primary solar effort is with the Southwest (Solar) Project in which 11 utilities are studying the technical and financial aspects of large-scale electric power generation and methods of accelerating commercialization of solar generation of electricity.

The Company joined with the Texas Energy Advisory Council to develop a wind power proposal for the Department of Energy and sponsored preliminary research explorations to determine the geothermal resource potential at a site immediately east of the City of El Paso. A second site is being studied by the University of Texas at El Paso under partial sponsorship of the Company.

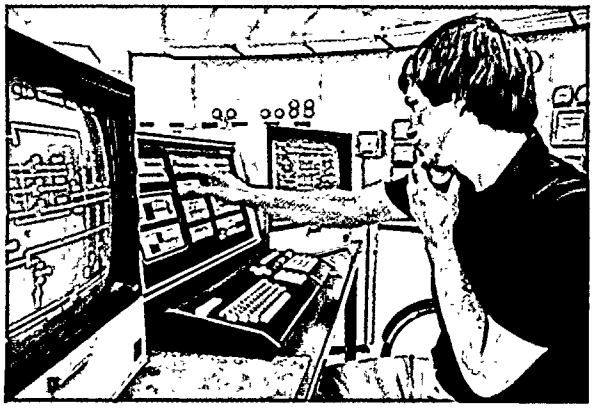
Through the Electric Power Research Institute and directly, the Company continued its load research program, designed to find ways to control peak demand and to reduce capital expenditures to meet that demand. Such alternate costing methods as peak-load pricing and time-of-day metering are under study for their possible long-range advantage to customers.

Energy Conservation Advanced Through Public Information

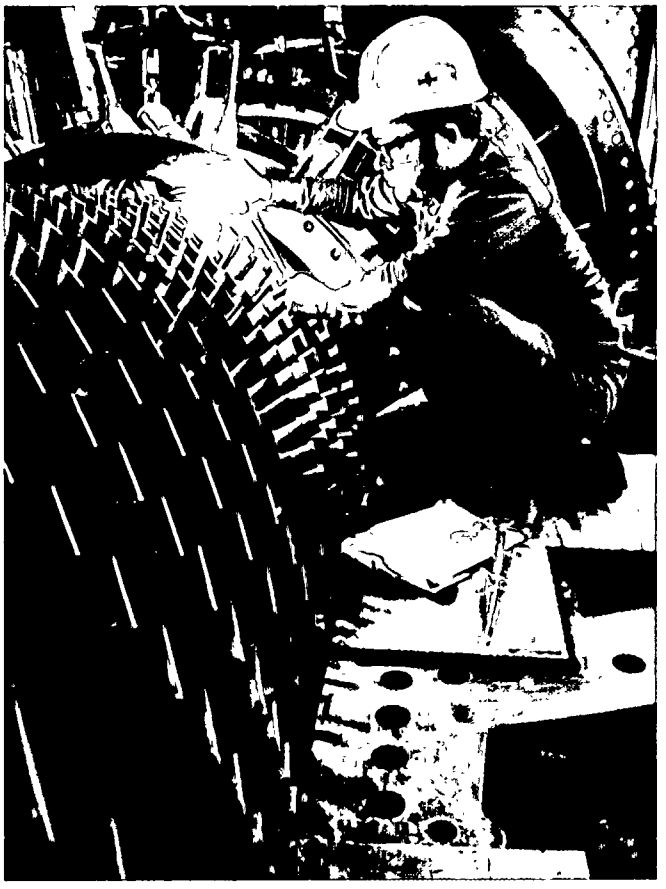
A program of intensive education on energy conservation, drawing participation by a number of Company divisions and departments, has been well received in the community.

A booklet entitled "82 Ways to Help Control Your Energy Bill" has been distributed to 35,000 customers. Consumer information of a general nature is presented in the Company's monthly bill insert, "The Electric Guide."

Because attitude research has indicated that much of the public is unaware how electricity is generated, the Company is presenting such information along with energy-saving information and safety programs through its public school assistance program. The Community Services Department, which is responsible for much of the in-the-field contact with consumers, is cooperating with local school districts by providing teacher training and study materials.



An electronic system of lights and lines on a curved map of the Company's distribution system continuously monitors service and signals when trouble strikes.



Complex tasks are performed by El Paso Electric employees to serve customers more efficiently. Clockwise: a lineman prepares to extend or repair service; a customer contact clerk reviews customer records quickly and accurately; a maintenance mechanic repairs the blades of a steam turbine; effective customer contact is taught in human relations course.

A new Company unit, the Energy Utilization and Conservation Department, has been organized and trained in the latest energy saving techniques. An important activity is the energy audit for industries, commercial customers and individual families. Following an inspection, the department representative suggests insulation needs, changes in energy use patterns and other steps with calculable cost savings and payback estimates.

To provide an energy-saving motivation to the growing number of apartment dwellers in the service area, El Paso Electric is working with the El Paso Apartment Association in converting master-metered complexes to individual metering for the units.

The Company continues to encourage construction of the WISE (Weatherized and Insulated to Save Energy) Home among local home builders and to make the public aware of the advantages. Retrofitting of existing homes to energy-efficient standards is also being supported.

Labor Agreement, Stock Ownership Plan Among Employee Relations Highlights

At year's end El Paso Electric employed 908 men and women. The Company's employees completed the year with a disabling injury frequency rate well below the national average.

All eligible employees may participate in the Company's Stock Purchase Plan through payroll deductions for purchase of Common Stock without commission or brokerage fees and are automatically enrolled in the Employee Stock Ownership Plan (ESOP) after at least three years' continuous service with the Company. This Plan allows the Company, through tax credits, to reduce its federal taxes provided it contributes the resulting tax saving toward the purchase of shares of its own stock for employees.

A two-year labor agreement between the Company and the International Brotherhood of Electrical Workers, which represents approximately 325 bargaining unit employees, became effective March 1, 1978. The two year agreement provided for wage increases of 8 percent effective March 1, 1978, 5 percent on March 1, 1979 and 5 percent on September 1, 1979.

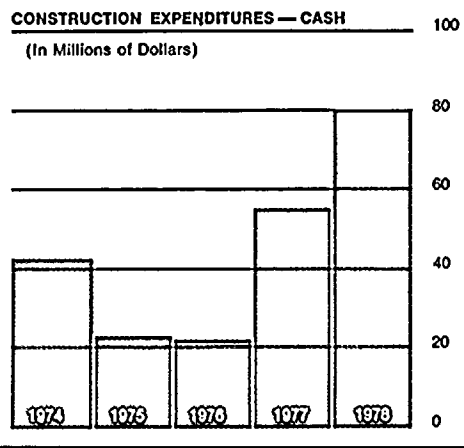
When space needs caused the Company move to larger office quarters, a project now nearing completion, community considerations were important in selection of the 12-story Mills Building in downtown El Paso. The Mills Building is one of the West's architecturally important and historically significant buildings. Preserving its striking design and decor, the Company has at the same time provided a facility conducive to more orderly, efficient operations than has been possible in the overcrowded Martin Building, the Company's headquarters for the past 60 years.

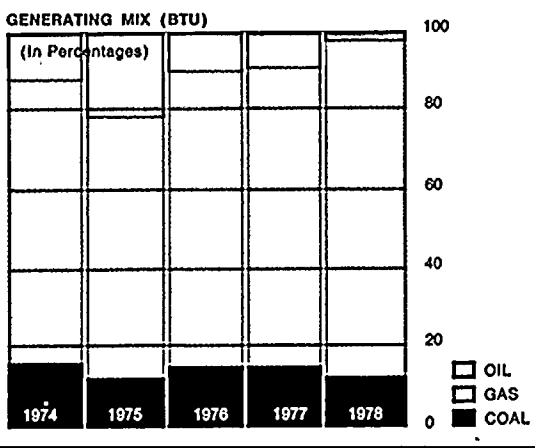
In actions designed to improve and strengthen the organization of the Company, the Board of Directors approved the promotion of Billye E. Bostic from Vice President — Finance to Senior Vice President. Mr. Bostic will be responsible for all accounting, financial and rate activities of the Company.

The Board also approved the promotion of Charles Mais from Assistant to the President to the position of Administrative Vice President. Mr. Mais will direct the Company's Consumer Affairs, Community Services, Employee Services and Public Affairs Departments.

William Johnson was promoted from Administrative Assistant to Controller and is responsible for certain accounting and financial activities of the Company.

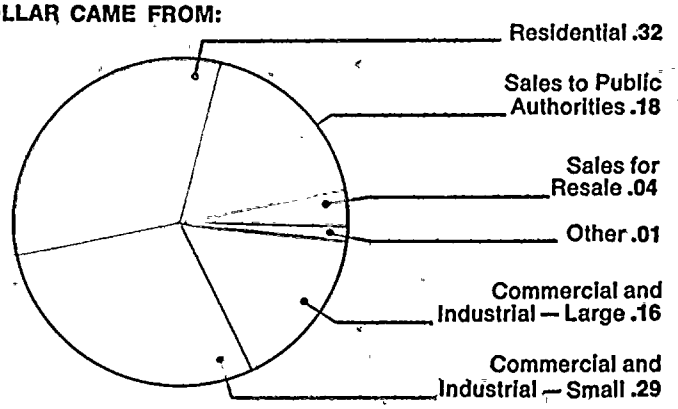
All other officers were re-elected to their respective positions.



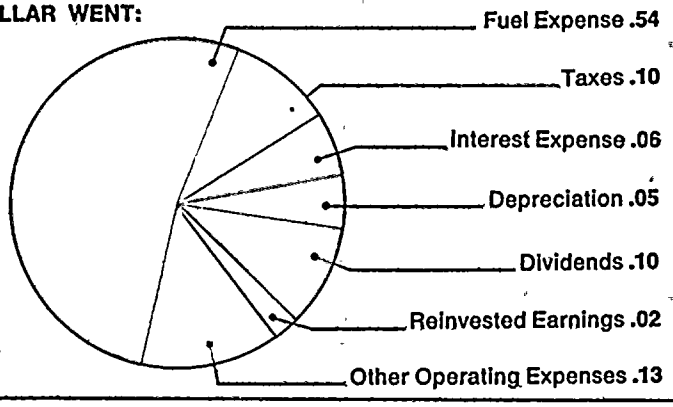


FINANCIAL INFORMATION
(Not covered by Report of Independent Certified Public Accountants)

WHERE THE REVENUE DOLLAR CAME FROM:



WHERE THE REVENUE DOLLAR WENT:



MARKET PRICES OF COMMON STOCK AND DIVIDENDS
(Not covered by Report of Independent Certified Public Accountants)

The following table indicates the high and low price of the common stock and dividends paid for the quarters indicated:

Quarter	Bid Price Range High	Low	Dividends
1978			
First-Quarter	11⅞	10⅞	$0.25
Second-Quarter	11⅜	10⅜	0.25
Third-Quarter	11½	10½	0.26
Fourth-Quarter	10¾	9⅞	0.26
1977			
First-Quarter	12⅛	11⅛	$0.24
Second-Quarter	12⅛	11	0.25
Third-Quarter	12⅝	11⅝	0.25
Fourth-Quarter	12¼	11⅜	0.25

El Paso Electric Company Common Stock is traded in the over-the-counter market.

The tabulation, which sets forth the high and low bid prices and represents prices between dealers, does not include retail markups, markdowns or commissions.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY
CONSOLIDATED BALANCE SHEET

ASSETS	December 31, 1978	December 31, 1977
	(In thousands)	
Utility plant:		
Electric plant (Notes B and E)	$438,085	$338,598
Accumulated provision for depreciation	(68,672)	(61,451)
	369,413	277,147
Nonutility property, at cost	1,563	24
Accumulated provision for depreciation	(27)	
	1,536	24
Current assets:		
Cash (Note F)	6,032	4,347
Restricted cash (Note B)		6,600
Accounts receivable (less allowance for doubtful accounts of $228,000 and $260,000, respectively)	15,325	14,383
Federal income taxes refundable	6,038	4,027
Materials and supplies	2,821	2,618
Fuel (Note H)	8,849	6,202
Prepayments	1,788	1,516
Deferred fuel costs	1,823	7,234
Other	303	837
	42,979	47,764
Deferred charges and other assets:		
Unamortized debt expense	808	662
Other	1,239	1,313
	2,047	1,975
	$415,975	$326,910

The accompanying notes are an integral part of the consolidated financial statements.

LIABILITIES AND SHAREHOLDERS' EQUITY	December 31, 1978	December 31, 1977
	(In thousands)	
Shareholders' equity:		
Preferred stock, cumulative, no par value, 1,000,000 shares authorized, 430,000 and 290,000 shares outstanding, respectively (Note C)	$ 42,873	$ 28,873
Common stock, no par value, 15,000,000 shares authorized, issued and outstanding 11,191,371 and 8,536,818 shares, respectively (Note D)	71,269	41,064
Unamortized capital stock expense	(788)	(496)
Retained earnings (Note E)	41,541	39,056
	154,895	108.497
Long-term debt (Note E)	126,152	118,171
Current liabilities:		
Notes payable to banks (Note F)	26,600	10,865
Commercial paper (Note F)	32,175	25,300
Fuel purchase commitment (Note H)	8,747	6,100
Accounts payable, principally trade	8,982	9,805
Customer deposits	2,447	1,997
Taxes accrued (Note G)	5,419	4,287
Deferred income taxes (Note G)	1,021	3,875
Interest accrued	2,831	2,322
Other	2,000	777
	90,222	65,328
Deferred credits and other liabilities:		
Accumulated deferred federal income taxes (Note G)	17,998	16,644
Accumulated deferred investment tax credit (Note G)	19,191	11,265
Customer advances for construction and other	354	405
	37,543	28,314
Long-term purchase commitment (Note B)	7,163	6,600
Commitments and contingencies (Notes H and J)		
	$415,975	$326,910

The accompanying notes are an integral part of the consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY
CONSOLIDATED STATEMENT OF INCOME
For the years ended December 31, 1978 and 1977

	1978	1977
	(In thousands)	
Operating revenues	$136,556	$112,339
Operating expenses (Note J):		
Fuel	73,447	59,442
Purchased and interchanged power	(2,110)	(1,947)
Operation	17,722	13,984
Maintenance	5,559	4,648
Depreciation (Note B)	7,361	6,498
Taxes (Note G):		
Federal income, current	(2,617)	20
Federal income, deferred	(1,500)	2,635
Charge equivalent to investment tax credit, net of amortization	9,014	1,894
Other	9,231	7,828
	116,107	95,002
Operating income	20,449	17,337
Other income:		
Allowance for other funds used during construction (Note I)	3,197	1,600
Other income, net of other expenses	954	162
Federal income taxes (Note G)	(463)	(73)
	3,688	1,689
Income before interest charges	24,137	19,026
Interest charges:		
Interest on long-term debt	9,477	8,161
Other interest (Note B)	4,041	1,554
Other interest capitalized (Note B)	(1,098)	
Allowance for borrowed funds used during construction (Note I)	(4,307)	(2,111)
	8,113	7,604
Net income (Note I)	16,024	11,422
Preferred dividend requirements (Note C)	2,575	2,037
Net income applicable to common stock (Note D)	$ 13,449	$ 9,385
Earnings per share of common stock (Notes D and I)	$1.30	$1.11
Weighted average number of common shares outstanding	10,333,109	8,488,340

The accompanying notes are an integral part of the consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

(In thousands, except share amounts)

	Preferred Stock		Common Stock			
	Shares	Dollars	Shares	Dollars	Unamortized Capital Stock Expense	Retained Earnings
Balance at December 31, 1976	190,000	$19,041	8,448,767	$40,033	($437)	$38,132
Net income for the year ended December 31, 1977						11,422
Amortization of capital stock expense					56	(56)
Cash dividends:						
Preferred						(2,037)
Common ($0.99 per share)						(8,405)
Shares issued to employee stock purchase plan			8,967	96		
Sale of shares to dividend reinvestment plan participants			79,084	935		
Sale of preferred stock	100,000	9,832				
Additions to capital stock expense					(115)	
Balance at December 31, 1977	290,000	28,873	8,536,818	41,064	(496)	39,056
Net income for the year ended December 31, 1978						16,024
Amortization of capital stock expense					139	(139)
Cash dividends:						
Preferred						(2,575)
Common ($1.02 per share)						(10,825)
Sale of shares to employee stock purchase plan participants			11,120	111		
Shares issued to employee stock ownership plan			26,529	294		
Sale of shares to dividend reinvestment plan participants			116,904	1,263		
Sale of common stock			2,500,000	28,537		
Sale of preferred stock	140,000	14,000				
Additions to capital stock expense					(431)	
Balance at December 31, 1978	430,000	$42,873	11,191,371	$71,269	($788)	$41,541

The accompanying notes are an integral part of the consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

For the years ended December 31, 1978 and 1977

	1978	1977
	(In thousands)	
Source of funds:		
From operations:		
Net income	$ 16,024	$ 11,422
Items not requiring outlay of working capital in the current period:		
Depreciation	7,361	6,498
Deferred federal income tax	1,354	1,323
Investment tax credit	9,014	1,894
Allowance for other funds used during construction	(3,197)	(1,600)
Other	223	184
Funds provided by operations	30,779	19,721
Other sources:		
Sale of preferred stock	14,000	9,832
Sale of common stock	30,205	1,031
Sale of first mortgage bonds	9,000	25,000
Sale of pollution control bonds		1,000
Long-term mortgages	2,124	
Long-term purchase commitment	563	6,600
Advances for construction and other	(51)	34
	86,620	63,218
Application of funds:		
Gross additions to plant	100,101	64,747
Allowance for other funds used during construction	(3,197)	(1,600)
Gross additions to other property and investments	1,539	
Increase (decrease) in other deferred debits	(74)	479
Dividends on preferred stock	2,575	2,037
Dividends on common stock	10,825	8,405
Capital stock expenses	431	115
Reduction of long-term debt	1,000	
Increase in bond discount	2,196	125
Other	903	(368)
	116,299	73,940
Decrease in working capital	($29,679)	($10,722)

The accompanying notes are an integral part of the consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY
CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION — (Continued)
For the years ended December 31, 1978 and 1977

	1978	1977
	(In thousands)	
Increase (decrease) in components of working capital:		
Current assets:		
Cash	$ 1,685	$ 1,343
Restricted cash	(6,600)	6,600
Accounts receivable	942	(416)
Federal income tax refundable	2,011	1,993
Materials and supplies	203	(94)
Fuel	2,647	(2,065)
Prepayments	272	227
Deferred fuel costs	(5,411)	1,894
Other	(534)	837
	(4,785)	10,319
Current liabilities:		
Notes payable	15,735	7,365
Commercial paper	6,875	3,100
Current installments of long-term debt	1,045	
Fuel purchase commitment	2,647	6,100
Accounts payable	(823)	4,692
Customer deposits	450	304
Taxes accrued	1,132	(2,469)
Deferred income taxes	(2,854)	1,312
Interest accrued	509	563
Other	178	74
	24,894	21,041
Decrease in working capital	($29,679)	($10,722)

The accompanying notes are an integral part of the consolidated financial statements.

A. Summary of Significant Accounting Policies:

General — The Company maintains its accounts in accordance with the Uniform System of Accounts prescribed for electric utilities by the Federal Energy Regulatory Commission (FERC).

Principles of Consolidation — The consolidated financial statements include El Paso Electric Company and its wholly-owned subsidiary, Franklin Land & Resources, Inc., which was organized in 1977. All intercompany balances and significant intercompany transactions have been eliminated in consolidation.

Utility Plant — Utility plant and equipment are stated at original cost. The Company provides for depreciation on a straight-line basis at annual rates which will amortize the undepreciated cost of depreciable property over estimated remaining service lives.

The Company charges the cost of repairs and minor replacements to the appropriate operating expense and capitalizes the cost of renewals and betterments. The recorded cost of depreciable plant retired or sold, and the cost of removal, less salvage, is charged to accumulated provision for depreciation.

Inventories — Materials and supplies and fuel inventories are valued at the lower of average cost or market.

Unamortized Capital Stock Expense — Unamortized amounts apply to outstanding issues and are being charged to retained earnings over a ten-year period.

Revenues — Revenues are recognized based on cycle billings rendered to customers monthly. The Company does not accrue revenues in respect of energy consumed but not billed at the end of a fiscal period.

Deferred Fuel Costs — Fuel costs in excess of base rates provided for by fuel adjustment clauses in applicable authorized rate schedules, which are billed in periods after the month the costs are incurred, are deferred until the related revenues are billed.

Unamortized Expense, Premium and Discount on Debt — Unamortized amounts apply to outstanding issues and are being amortized ratably over the lives of such issues.

Federal Income Taxes and Investment Tax Credits — Accelerated depreciation of utility plant and amortization of emergency facilities are used for federal income tax reporting purposes which differs from the methods used for financial reporting purposes. Differences in the tax and financial methods of accounting for fuel costs also exist. In accordance with regulatory authority requirements provision has been made in the financial statements for federal income taxes deferred to future years as a result of these items. The Company does not provide deferred taxes on certain other differences between financial and tax reporting since such differences are not approved as an expense in rate of return computations by regulatory authorities.

Investment tax credits are deferred and amortized to income over the estimated service lives of the related properties.

Pension Plan — The Company has a noncontributory retirement annuity plan (future participation terminable at any time) under a group annuity contract. The pension plan provides annual pensions for regular employees with more than one year of service. The Company's policy is to fund pension costs accrued. Prior service costs are being amortized over a thirty-year period beginning in 1972 and are included in the determination of annual expenses.

Earnings Per Common Share — Earnings per common share are computed using the weighted average number of common shares outstanding during the year. Common equivalent shares related to the Amended Employee Stock Purchase Plan are not significant.

B. Utility Plant:

Electric plant consisted of the following at December 31, 1978 and 1977:

	1978	1977
	(In thousands)	
Intangibles	$ 50	$ 50
Production	130,714	130,216
Transmission	47,159	30,629
Distribution	92,959	84,699
General	9,324	8,468
Plant held for future use	397	397
Construction work in progress	143,826	79,762
Nuclear fuel and other investments	13,656	4,377
Total	$438,085	$338,598

At December 31, 1978 a commitment in the amount of approximately $7,163,000 to purchase a turbine from a Trust has been included in construction work in progress. In connection with this commitment the balance sheet at December 31, 1977 includes funds borrowed by the Trust in the amount of approximately $6,600,000 which were used to acquire turbine rights from the Company and were reflected as restricted cash at December 31, 1977. Corresponding amounts have been reflected as a long-term purchase commitment at December 31, 1977 and 1978.

During the year ended December 31, 1978 interest in the amount of approximately $1,098,000 relative to funds borrowed by a Trust and the Company's subsidiary was capitalized. The borrowed funds at rates ranging from 4¼% to 11¾% were used to acquire utility plant (construction work in progress and nuclear fuel properties and other investments). The interest amount has been included in the Consolidated Statement of Income as "Other Interest" with a corresponding amount included in "Other Interest Capitalized." Interest amounts prior to January 1, 1978 were minimal.

The Company has a 7% undivided interest in Units 4 and 5 of the Four Corners Project located in northwestern New Mexico and a 15.8% undivided interest in Units 1, 2 and 3 of Palo Verde Nuclear Generating Station which is under construction near Phoenix, Arizona. The participants in these plants are responsible for obtaining their respective financing. The extent of Company interests in these jointly-owned plants is as follows at December 31, 1978 and 1977:

	1978		1977	
	Palo Verde Nuclear Generating Station	Four Corners Project	Palo Verde Nuclear Generating Station	Four Corners Project
		(In thousands)		
Utility plant (in service)		$13,524		$13,210
Accumulated provision for depreciation		2,362		2,018
Utility plant (under construction)	$135,600	848	$58,473	298

The Company's direct expenses associated with the Four Corners Project are included in the applicable operating expense categories of the Consolidated Statement of Income.

Total depreciation was approximately $6,734,000 in 1977 and $7,616,000 in 1978, of which approximately $236,000 and $255,000, respectively, was applicable to transportation equipment and has been charged to other accounts.

The average annual depreciation rate used by the Company for the years ended December 31, 1977 and 1978 was 2.68% and 2.93%, respectively.

C. Preferred Stock:

Following is a summary of the preferred stock outstanding at December 31, 1978 and 1977:

Issue	Stated Value 1978	Stated Value 1977	Call Price Per Share at December 31, 1978
	(In thousands)		
15,000 shares, $ 4.50 dividend	$ 1,534	$ 1,534	$109.00
15,000 shares, $ 4.12 dividend	1,506	1,506	103.98
20,000 shares, $ 4.72 dividend	2,001	2,001	104.00
40,000 shares, $ 4.56 dividend	4,000	4,000	100.00
100,000 shares, $10.75 dividend	10,000	10,000	110.75
100,000 shares, $ 8.24 dividend	9,832	9,832	107.52
140,000 shares, $ 8.44 dividend	14,000		108.44
	$42,873	$28,873	

The $10.75 preferred shares are entitled to the benefits of a sinking fund whereby on January 1 of each year, beginning in 1980, the Company will redeem 4,000 shares annually at the sinking fund redemption price of $100.00 per share plus accrued dividends. Sinking fund requirements are cumulative and in the event they are not satisfied at any redemption date, the Company is restricted from paying any dividends (other than dividends in common stock or other class of stock ranking junior to the preferred stock as to dividends and assets) on common stock. The $10.75 preferred shares are callable; however, no optional redemption of the shares may be made prior to January 1, 1985, as a part of, or in anticipation of, any refunding involving the issue of indebtedness or preferred stock having an effective interest or dividend cost of less than 10.75% per annum.

The $8.24 preferred shares have no provision for a sinking fund. The shares are callable; however, no optional redemption of the shares may be made prior to April 1, 1982, directly or indirectly as part of, or in anticipation of, any refunding involving the issue of indebtedness or preferred stock having an interest or dividend cost less than the effective dividend cost of the $8.24 preferred stock.

The $8.44 preferred shares are entitled to the benefits of a sinking fund whereby on October 1 of each year, beginning in 1984, the Company will redeem 4% of the aggregate number of shares

outstanding annually at the sinking fund redemption price of $100 per share plus accrued dividends. Sinking fund requirements on this issue are subject to the same cumulative restrictions as the $10.75 dividend preferred shares described below.

All preferred stock is callable and upon voluntary redemption or voluntary liquidation of the Company is redeemable at the current call price plus accrued dividends. The premiums reflected in the current redemption prices continue to decrease, ultimately resulting in redemption at par. All series are redeemable at $100 per share plus accrued dividends upon involuntary liquidation.

D. Common Stock:

Under a shareholder approved employee stock purchase plan qualified employees may purchase shares of the Company's common stock at two specified dates each year. The purchase price is 90% of the average bid price of the stock at the option dates. During 1977, 8,967 shares of common stock were purchased at a total price of approximately $96,000 with a corresponding fair market value at the purchase dates of approximately $106,000. During 1978, 11,120 shares were purchased at a total price of approximately $111,000 with a corresponding fair market value at the purchase date of approximately $117,000. At December 31, 1978, 73,595 shares were reserved for future purchases under the plan. Proceeds from purchases are credited to common stock and no charges are reflected in income with respect to the plan.

The Company has a Dividend Reinvestment and Stock Purchase Plan which provides holders of its common stock the option to invest cash dividends and/or optional cash payments (up to $3,000 per quarter) in additional shares of the Company's common stock. During 1977 and 1978, 79,084 and 116,904 shares were purchased by shareholders who reinvested dividends and cash in the amount of approximately $943,000 and $1,263,000, respectively. At December 31, 1978, 510,847 shares were reserved for future purchases under the plan. The purchase price is the average of the last bid and asked price at the purchase date.

The Company adopted an employee stock ownership plan in May 1978, pursuant to which it will contribute common stock, with a value equal to a specified amount of its investment tax credit, to the plan for the benefit of employees. The Company reserved 500,000 shares of common stock for issuance under the plan. In June 1978 the Company contributed approximately 26,529 shares of stock with a market value of approximately $294,000 to the plan. At December 31, 1978, 473,471 shares were reserved for future contributions under the plan.

Net income applicable to common stock, net income per share of common stock, and weighted average number of common shares outstanding for the year ended December 31, 1978, would have been $13,396,000, $1.13 and 11,868,561, respectively, assuming that the proceeds (before expenses of sale) of $17,208,000 from 1,500,000 shares issued in February 1978, $11,329,000 from 1,000,000 shares issued in August 1978, $6,804,000 from the sale of $9,000,000 principal amount of 6¾% first mortgage bonds issued in July 1978, $15,000,000 from 150,000 shares of preferred stock issued in October and November 1978 and January 1979, and $15,909,000 from 1,500,000 shares issued in January 1979 were used to retire short-term debt outstanding during the year ended December 31, 1978.

E. Long-Term Debt:

Outstanding long-term debt at December 31, 1978 and 1977 is as follows:

	1978	1977	Current Redemption Price
	(In thousands)		
First mortgage bonds:			
2⅞% Series, due 1980	$ 4,500	$ 4,500	$100.25
3⅛% Series, due 1984	4,950	4,950	101.05
4¼% Series, due 1988	6,100	6,100	102.15
4⅝% Series, due 1992	10,385	10,385	102.63
6¾% Series, due 1998	24,800	15,800	104.43
7¾% Series, due 2001	15,838	15,838	106.77
9% Series, due 2004	20,000	20,000	107.33
10½% Series, due 2005	15,000	15,000	110.23
8½% Series, due 2007	25,000	25,000	108.45
	126,573	117,573	
4¼% pollution control revenue bonds, 1977 Series A, due 1979	5,000	5,000	
Less funds on deposit with trustee	(4,000)	(4,000)	
Other 8.8125%, due in installments through 1998	2,169		
	129,742	118,573	
Current maturities of long-term debt	(1,045)		
Unamortized premium and discount	(2,545)	(402)	
	$126,152	$118,171	

Scheduled maturities of long-term debt at December 31, 1978 are as follows (in thousands):

1979	$ 1,045
1980	4,549
1981	54
1982	59
1983	64
Thereafter	123,971
	$129,742

The Company's indenture of mortgage provides for sinking and improvement funds which require the Company to make annual payments to the trustee equivalent to 1% ($1,185,000 at December 31, 1977 and $1,275,000 at December 31, 1978) of the greatest aggregate principal amount of bonds of the respective series outstanding at any one time prior to a specified date preceding the sinking fund payment date, with certain allowable credits. The Company has generally satisfied these requirements in past years by relinquishing the right to use a net amount of additional property for the issuance of bonds or purchasing bonds in the open market and expects to continue such practices in the future.

The premiums reflected in the redemption prices shown above continue at reduced amounts in future years, finally resulting in each case in redemption at par at maturity.

Substantially all of the Company's utility plant is subject to a lien under the indenture of mortgage collateralizing the Company's bonds.

In accordance with certain provisions of the indenture covering the first mortgage bonds, payment of cash dividends on common stock is restricted to an amount equal to retained earnings accumulated after December 31, 1966, plus $4,100,000. Retained earnings in the amount of

approximately $24,000,000 is unrestricted as to the payment of cash dividends at December 31, 1978, which includes the effect of a change in July 1978 in the method of calculating operating revenues (as defined) in determining the minimum provision for depreciation.

The funds on deposit with a trustee ($4,000,000) at December 31, 1977 and 1978, represent a portion of the proceeds from pollution control revenue bonds issued in November 1977. The funds will be withdrawn from the trustee account as qualified construction expenditures for pollution control facilities are made.

F. Notes Payable to Banks and Commercial Paper:

Short-term notes at December 1978, consist of $32,175,000 of commercial paper with an effective weighted average interest rate of 10.4% and $26,600,000 of notes payable to banks with an effective weighted average interest rate of 10.6%. Short-term notes at December 31, 1977, consist of $25,300,000 of commercial paper with a weighted average interest rate of 6.5% and $10,865,000 of notes payable to banks with a weighted average interest rate of 6.4%.

The Company and its subsidiary have informal lines of credit with various lenders whereby the lenders have agreed to provide specified maximum amounts as a temporary source of funds for its capital program. Certain of these arrangements provide for the maintenance of compensating balances of 10% of the available lines of credit and 10% of the loans outstanding. At December 31, 1977 and 1978, the lines of credit available under these arrangements totaled $55,600,000 (including subsidiary lines of $4,000,000) and $67,925,000 (including subsidiary lines of $10,925,000), respectively, and approximately $1,300,000 and $2,550,000, respectively, of the Company's cash at these dates was maintained as compensating balances.

The maximum and average amounts of aggregate short-term borrowings outstanding at any month-end during the year ended December 31, 1978, were $58,775,000 and $43,054,000, respectively, and for the year ended December 31, 1977, were $36,750,000 and $23,598,000, respectively. The weighted average interest rate was 7.4% and 5.5% during the year ended December 1978 and 1977, respectively, and was calculated by dividing actual interest expense and applicable capitalized interest by the average month-end balances outstanding during the related period.

Through December 31, 1980 the FERC has authorized the Company to incur short-term debt (in the form of promissory notes or commercial paper) not to exceed $130,000,000 outstanding at any one time. The interest rates on the notes are not to exceed the prime rate in effect at the time of issuance, plus in some cases, provisions for compensating balances of 20%.

G. Federal Income Taxes:

The provision for deferred federal income tax, which arises from timing differences between financial and tax reporting, is comprised as follows for the years ended December 31, 1978 and 1977:

	1978	1977
	(In thousands)	
Tax effect of:		
Excess of accelerated tax depreciation over straight-line tax depreciation	$ 1,572	$1,599
Deferred fuel costs	(2,597)	909
Amortization related to emergency facilities	(111)	(111)
Deferred rate case expense and other	(364)	238
	($1,500)	$2,635

Federal income tax provisions for the years ended December 31, 1977 and 1978 are less than the amounts computed by applying the statutory rate (48%) to book income before tax. Details are as follows for the years ended December 31, 1978 and 1977:

	1978	1977
	(In thousands)	
Tax computed at statutory rate on book income before tax	$10,264	$7,701
Increases (decreases):		
Allowance for funds used during construction	(3,602)	(1,781)
Excess of straight-line tax depreciation over book depreciation	(348)	(707)
Amortization of accumulated investment tax credit	(398)	(297)
Other	(556)	(294)
Total income tax expense	$ 5,360	$4,622
Effective federal income tax rate	25.1%	28.8%

Total federal income tax expense is comprised as follows for the years ended December 31, 1978 and 1977:

	1978	1977
	(In thousands)	
Federal income tax, current (credit)	($2,617)	$ 20
Income taxes associated with other income	463	73
Federal income tax currently payable (receivable)	(2,154)	93
Deferred federal income tax	(1,500)	2,635
Deferred investment tax credit	9,412	2,191
Amortization of deferred investment tax credit	(398)	(297)
	$ 5,360	$4,622

H. Commitments and Contingencies:

The Company is committed for the future development of utility plant at December 31, 1978, in the amount of approximately $691,000,000, which consists of a 15.8% interest in the construction of three units of a nuclear power plant (expected to be completed in 1986), related transmission lines, and nuclear fuel, including approximately $189,000,000 of estimated allowance for funds used during construction. In addition, the Company is committed at December 31, 1978, in the amount of approximately $17,700,000, for construction of pollution control facilities, including approximately $2,400,000 of estimated AFUDC. The above amounts were computed using an annual inflation rate of 7%.

The Company's fuel supply arrangements include short-term commitments under a fuel supply arrangement entered into in 1977 with a trust, whereby the Company concurrently assigned its principal long-term fuel supply contract to the trust and agreed to purchase all fuel oil delivered to the trust by the fuel supplier. Payments to the trust for fuel oil purchases consist of the trust's cost of oil determined on an average cost basis plus related administrative and carrying costs. For financial reporting purposes, purchases of the trust are assumed to have been made on behalf of the Company. Accordingly, the balance sheet at December 31, 1978, includes an amount of $8,747,000 which is reflected as fuel and fuel purchase commitment, reflecting the Company's commitment to purchase the trust's fuel oil inventory as of that date.

The Company's operations are subject to environmental protection measures imposed under federal and state laws and regulations.

The Company's rates including fuel adjustment clauses, are subject to the jurisdiction of local, state, and federal authorities.

I. Allowance for Funds Used During Construction:

The applicable regulatory uniform system of accounts provides for "allowance for funds used during construction" ("AFUDC") which is defined as an amount which includes the net cost during a period of construction of borrowed funds used for construction purposes plus a reasonable rate on other funds when so used. While AFUDC results in a current increase in utility plant for rate-making purposes and represents, in this fashion, current compensation for the use of capital devoted to construction, AFUDC is not an item of current cash income. AFUDC is realized in cash after the related plant is placed in service through the allowance for depreciation charges based on the total cost of the plant, including AFUDC.

The amount of AFUDC is determined by applying an accrual rate to the balance of certain utility plant additions. The Company used an accrual rate of 7½% in 1977. During 1978, the Company changed the rate used to calculate AFUDC from 7½% to 9½%, effective as of January 1, 1978. In this connection, the FERC promulgated procedures for the computation (a prescribed formula) of the accrual rate which were effective January 1, 1977. The rates used by the Company are lower than those permitted under the prescribed FERC formula.

The increase in the AFUDC rate as of January 1, 1978, increased net income by approximately $1,580,000 and earnings per share by approximately $.15 for the year ended December 31, 1978.

J. Pension Plan:

After reflecting dividends earned by its pension fund, the Company had $560,000 of pension expense in 1977 and $680,000 in 1978. The assets of the pension fund exceeded the vested benefits at December 31, 1978; and the unfunded prior service benefits were estimated to be approximately $3,500,000 as of June 30, 1978, which is the date of the most current actuarial valuation.

K. Quarterly Financial Summary (Unaudited):

The following table sets forth the quarterly financial summary of the Company for the years ended December 31, 1978 and 1977.

(In Thousands of Dollars Except for Per Share Data)
(All Quarterly Data is Unaudited)

	Operating Revenues	Operating Expenses	Operating Income	Net Income	Net Income Applicable to Common Stock	Net Income Per Common Share
1978						
1st quarter	$31,418	$27,142	$4,276	$2,812	$2,236	$.24
2nd quarter	36,219	30,899	5,320	3,883	3,307	.33
3rd quarter	37,787	31,470	6,317	5,133	4,556	.43
4th quarter	31,132	26,596	4,536	4,196	3,350	.30
1977						
1st quarter	28,134	23,943	4,191	2,613	2,242	.27
2nd quarter	26,841	22,426	4,415	2,753	2,240	.26
3rd quarter	31,183	25,987	5,196	3,711	3,135	.37
4th quarter	26,181	22,646	3,535	2,345	1,768	.21

L. Replacement Cost Information (Unaudited):

The impact of inflation experienced in recent years has resulted in replacement costs of productive capacity that are significantly greater than the historical costs of such assets reported in the Company's financial statements. The Company's ability to maintain its productive capacity in the future will be contingent upon its ability to finance the needed additions. This, in turn, will depend on the Company's ability to obtain adequate and timely rate relief. The Company retained Stone & Webster Appraisal Corporation of Boston, Massachusetts ("Stone & Webster Appraisal") to determine the approximate replacement cost of the Company's productive capacity.

The replacement cost information does not purport to represent the current value or reproduction costs of the assets or the amounts which could be realized if the assets were sold. Rather, replacement cost generally represents the estimated amount that would be required to replace, at today's prices, the productive capacity of certain of the Company's existing assets with assets of a modern type including additional pollution control equipment presently required under environmental regulations. Such replacement would result in changes in fuel, operation and maintenance cost which are not reflected in the data submitted.

The replacement costs reflected in the table below were determined on the basis of replacing existing capacity (which uses gas, oil and coal as fuels) with capacity fueled by oil and coal. Due to federal legislation in connection with a national energy policy, replacement of existing capacity with capacity fueled by oil may no longer be a viable alternative. To the extent existing capacity must be replaced by capacity using coal or nuclear fuel, replacement costs could be expected to increase substantially.

The difference between historical and replacement cost of net plant investment does not represent additional book value for the Company's common stock; instead, it indicates the capital funds (in excess of booked depreciation and other prior capital provisions) that may have to be provided to replace existing service capacity of the plant of the Company.

The Company's business is subject to the jurisdiction of regulatory commissions in the determination of fair rates of return on its investment in utility plant. Under current ratemaking policy, the Company recovers, through future depreciation charges, the historical dollars invested in productive capacity. The ratemaking process does not allow the Company to recover the excess of replacement cost over historical cost. However, at such time as amounts are actually expended to replace existing assets, such amounts will be considered in determining the Company's rate base for purposes of ratemaking.

The Company believes that the difference between depreciation based on historical cost and depreciation based on estimated replacement cost, which difference is not deductible in determining income tax expense, is not truly an additional amount of depreciation expense. Rather, it is a measure of the extent to which the Company should be making provision in the current year for replacement of its existing plant, assuming no growth in demands for service and no further inflation in costs.

The consolidated replacement cost information on a comparative basis with historical cost is shown in the tabulation below for the years ended December 31, 1978 and 1977 (amounts in thousands):

	1978		1977	
	Estimated Replacement Cost	Actual Historical Cost	Estimated Replacement Cost	Actual Historical Cost
Plant investment subject to replacement cost disclosure°	$854,720	$438,085	$709,300	$338,598
Accumulated depreciation	171,808	68,672	151,840	61,451
Net plant investment	$682,912	$369,413	$557,460	$277,147
Depreciation expense for the year	$ 18,089	$ 7,616	$ 15,136	$ 6,734

° Amounts exclude nonutility plant of approximately $24,000 and $1,563,000, and include land, nuclear fuel and other investments, intangible assets and construction work in progress at original cost of approximately $86,700,000 and $160,750,000 for the years ended December 31, 1977 and 1978, respectively.

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

To the Shareholders and Board of Directors
El Paso Electric Company:

We have examined the consolidated balance sheet of El Paso Electric Company and Subsidiary at December 31, 1978 and 1977, and the related consolidated statements of income, shareholders' equity and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above present fairly the consolidated financial position of El Paso Electric Company and Subsidiary at December 31, 1978 and 1977, and the consolidated results of operations and changes in financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Dallas, Texas
February 16, 1979

COOPERS & LYBRAND

SUMMARY OF OPERATING DATA

	1978	1977	1976
Population served at retail, estimated(a)	544,000	532,000	520,000
Number of customers:			
Residential	150,739	143,645	135,344
Commercial and industrial, small	15,381	14,518	14,203
Commercial and industrial, large	47	46	39
Other	1,842	1,715	1,748
Total	168,009	159,924	151,334
Annual system peak load, net kilowatts	690,000	657,000	677,000
Output, net generated and purchased, thousand kilowatt-hours:			
Steam	3,673,685	3,475,753	3,501,416
Purchased and interchanged	(84,609)	(3,574)	51,013
Total(b)(c)	3,589,076	3,472,179	3,552,429
Sales of electricity, thousands of dollars:			
Residential	$ 44,178	$ 34,484	$ 31,415
Commercial and industrial, small	39,780	33,583	33,628
Commercial and industrial, large	22,402	17,666	15,709
Other	29,289	25,581	29,537
Total	$ 135,649	$ 111,314	$ 110,289
Sales, thousand kilowatt-hours:			
Residential	907,956	874,140	816,169
Commercial and industrial, small	913,038	902,699	929,556
Commercial and industrial, large	650,542	617,955	582,125
Other	849,113	847,930	1,030,812
Total(b)(c)	3,320,649	3,242,724	3,358,662
Average annual use per residential customer, kwh	6,153	6,261	6,193
Average annual revenue per residential customer	$ 299.40	$ 246.99	$ 238.36
Average revenue per kwh sold, cents:			
Residential(d)	4.87	3.94	3.85
Commercial and industrial, small(d)	4.36	3.72	3.62
Commercial and industrial, large(d)	4.14	3.47	2.70
Average revenue per kwh; total sales(d)	4.09	3.45	3.30
Electric line, pole miles:			
Over 15,000 volts	1,999	1,811	1,759
Less than 15,000 volts(e)	2,759	2,755	2,727
Total	4,758	4,566	4,486
Total employees	908	838	816

(a) Restated as a result of 1970 census.

(b) Differences between total output and total sales represent company use and losses.

(c) In addition to the Company's 345 kv transmission line between El Paso and Albuquerque, the company system is interconnected at Las Cruces, New Mexico, with Public Service Company of New Mexico, Community Public Service Company, Plains Electric Generation and Transmission Cooperative, Inc., and Elephant Butte Generating Station through the facilities of the United States Bureau of Reclamation under a pool agreement.

(d) Includes adjustments under existing fuel clauses.

(e) Includes small amount of line on poles owned by telephone company.

1975	1974	1973	1972	1971	1970	1969
505,000	495,000	485,000	475,000	465,000	450,000	435,000
130,010	126,760	123,653	119,170	114,640	110,308	107,284
13,294	13,163	12,816	12,333	11,666	11,279	11,129
32	29	27	27	23	21	19
1,663	1,545	1,445	1,351	1,255	1,228	1,188
144,999	141,497	137,941	132,881	127,584	122,836	119,620
640,000	638,000	618,000	543,400	500,700	469,100	448,300
3,433,698	3,369,606	3,450,021	3,075,013	2,705,160	2,506,048	2,460,571
15,837	(13,709)	(180,767)	(112,435)	(43,375)	360	536
3,449,535	3,355,897	3,269,254	2,962,578	2,661,785	2,506,408	2,461,107
$ 27,080	$ 20,126	$ 16,749	$ 15,133	$ 14,081	$ 13,099	$ 12,535
28,870	19,192	14,942	12,948	11,515	10,336	9,739
11,816	7,824	6,061	5,231	4,517	4,194	3,411
22,880	15,595	11,416	9,696	8,565	8,155	8,004
$ 90,646	$ 62,737	$ 49,168	$ 43,008	$ 38,678	$ 35,784	$ 33,689
782,285	765,636	755,701	694,855	643,313	598,240	571,454
909,967	853,960	799,997	696,584	610,876	540,529	526,275
513,637	508,482	536,754	487,945	440,568	426,177	374,694
1,006,311	980,175	958,252	853,978	758,769	763,597	836,802
3,212,200	3,108,253	3,050,704	2,733,362	2,453,526	2,328,543	2,309,225
6,097	6,116	6,211	5,948	5,718	5,499	5,391
$ 211.04	$ 160.72	$ 137.59	$ 129.53	$ 125.16	$ 120.39	$ 118.25
3.46	2.63	2.22	2.18	2.19	2.19	2.19
3.17	2.25	1.87	1.86	1.89	1.91	1.85
2.30	1.54	1.13	1.07	1.03	.98	.91
2.82	2.02	1.61	1.57	1.58	1.54	1.46
1,706	1,647	1,581	1,539	1,503	1,442	1,343
2,691	2,673	2,616	2,565	2,507	2,457	2,394
4,397	4,320	4,197	4,104	4,010	3,899	3,737
778	726	704	659	644	629	637

SUMMARY OF OPERATIONS

(Thousands of Dollars) Year Ended December 31	1978	1977	1976
Operating revenues	$136,556	$112,339	$111,188
Fuel	73,447	59,442	53,154
Operation and maintenance	21,171	16,685	17,954
Depreciation(a)	7,361	6,498	6,233
Taxes	14,128	12,377	15,727
Other income	(3,688)	(1,689)	(838)
	112,419	93,313	92,230
Income before interest charges	24,137	19,026	18,958
Total interest charges	8,113	7,604	7,442
Income before cumulative effect on prior years of change in accounting method	16,024	11,422	11,516
Cumulative effect to January 1, 1974 of change in accounting for fuel costs, net of related income taxes $(912,000)			
Net income	$ 16,024	$ 11,422	$ 11,516
Earnings per share of common stock, based on weighted average number of shares outstanding during each year: Income applicable to common stock before cumulative effect of change in accounting method	$ 1.30	$ 1.11	$ 1.29
Cumulative effect to January 1, 1974 of change in accounting for fuel costs			
Net income applicable to common stock	$ 1.30	$ 1.11	$ 1.29
Pro forma amounts assuming the new method of accounting for fuel costs is applied retroactively(b): Net income applicable to common stock			
Earnings per share			
Dividends paid per share on common stock	$ 1.02	$ .99	$ .95
Electric plant	$438,085	$338,598	$274,502

(a) Does not include depreciation on automobiles and trucks, which was allocated to other accounts.

(b) The effect of the accounting change in years prior to January 1, 1971, is not significant.

1975	1974	1973	1972	1971	1970	1969
$ 91,461	$ 63,072	$ 49,483	$ 43,284	$ 38,919	$ 36,026	$ 33,933
44,714	24,914	15,766	10,951	8,974	7,330	6,525
14,516	11,463	8,160	8,101	7,717	7,149	6,578
5,506	4,345	4,102	3,776	3,509	3,256	2,936
11,197	9,809	9,573	9,279	8,151	8,194	8,639
(1,423)	(770)	(84)	(668)	(699)	(393)	(621)
74,510	49,761	37,517	31,439	27,652	25,536	24,057
16,951	13,311	11,966	11,845	11,267	10,490	9,876
6,853	5,280	3,962	3,591	3,450	3,073	2,768
10,098	8,031	8,004	8,254	7,817	7,417	7,108
	988					
$ 10,098	$ 9,019	$ 8,004	$ 8,254	$ 7,817	$ 7,417	$ 7,108
$ 1.30	$ 1.19	$ 1.19	$ 1.22	$ 1.16	$ 1.10	$ 1.05
	.15					
$ 1.30	$ 1.34	$ 1.19	$ 1.22	$ 1.16	$ 1.10	$ 1.05
		$ 8,270	$ 8,035	$ 7,481		
		$ 1.29	$ 1.25	$ 1.17		
$ .91	$ .88	$ .86	$ .83	$ .80	$ .76	$ .72
$250,375	$227,196	$185,058	$174,485	$166,275	$150,859	$143,350

EL PASO ELECTRIC COMPANY AND SUBSIDIARY
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF THE CONSOLIDATED STATEMENT OF INCOME

The factors discussed below, which may not be indicative of future operations or earnings, have had an effect upon the Company's results of operations during the years ended December 31, 1978 and 1977.

Operating Revenues

Following is a summary of the changes in operating revenues for the years ended December 31, 1978 and 1977 (In thousands):

				1977 Increase Over 1976		1978 Increase Over 1977	
	1976	1977	1978	Dollars	%	Dollars	%
Total operating revenues	$111,188	$112,339	$136,556	$1,151	1.0%	$24,217	21.6%

Operating revenues increased in 1978 over 1977 partially as a result of increased base rates (calculated without giving effect to the recovery of fuel costs). Base rates for 1978 were approximately .3¢ per kilowatt hour higher than those in 1977. Base rates, fuel (collected both in base rates and through fuel adjustment clauses) and volume accounted for approximately 45%, 50% and 5%, respectively of the total 21.6% increase in revenues in 1978 over 1977.

Revenue increases in 1977 over 1976 principally reflect a 5% increase in fuel costs which were offset in part by a 3% volume decrease in kilowatt hour sales resulting from the termination of sales, as of March 31, 1977, to the Comision Federal de Electricidad (the "Comision") which supplies the City of Juarez, Mexico. Prior to this termination, approximately 8% of the Company's revenues were derived from sales to the Comision. In 1976 the Comision purchased 232,104,000 kilowatt hours while in 1977 it purchased only 3,408,000 kilowatt hours, but this decrease was partially offset by increased sales to other customers in 1977. Base rate changes were insignificant during the period increasing only .01¢ per kilowatt hour in 1977 above 1976.

Operating Expenses

Following is a summary of the changes in operating expenses for the years ended December 31, 1978 and 1977 (In thousands):

				1977 Increase Over 1976		1978 Increase Over 1977	
	1976	1977	1978	Dollars	%	Dollars	%
Total operating expenses	$93,068	$95,002	$116,107	$1,934	2.1%	$21,105	22.2%

Increased operating expenses in 1978 over 1977 were due principally to escalating fuel costs, together with increases in the aggregate costs of purchased power, operation, maintenance and depreciation. Such costs accounted for approximately 91% of the total increase. Escalating fuel costs accounted for approximately 66% of the total increase. Increased operations expense (18% of the increase) were due to inflationary pressure on wages, employee benefits, materials and other costs. Increased depreciation expense, which accounted for approximately 4% of the increase was due to increases in depreciable property together with increased average annual rates in 1978. Increases in federal income taxes accounted for approximately 2% of the increase, while other taxes contributed 7% toward the total increase.

Operating expenses for 1977 increased over 1976 due to fuel and operation expense escalations partially offset by lower cost of purchased and interchanged power and federal income taxes. Such expenses accounted for almost 88% of the amount shown above. Purchased and interchanged power fluctuated in 1977 as a result of a substantial net credit for power delivered to another utility (which experienced a temporary major equipment failure) under an interchange agreement. Federal income tax decreased as a result of changes in taxable income.

Operating Income

Following is a summary of the changes in operating income for the years ended December 31, 1978 and 1977 (In thousands):

				1977 (Decrease) Over 1976		1978 Increase Over 1977	
	1976	1977	1978	Dollars	%	Dollars	%
Total operating income	$18,120	$17,337	$20,449	($783)	(4.3%)	$3,112	18.0%

Increases and/or decreases in operating income are directly related to change in operating revenues and operating expenses in their respective periods. (See the captions "Operating Revenues" and "Operating Expenses" above.)

Allowance for Funds Used During Construction

Following is a summary of the changes in AFUDC (borrowed and other components combined) for the years ended December 31, 1978 and 1977 (In thousands):

	1976	1977	1978	1977 Increase Over 1976 Dollars	1977 Increase Over 1976 %	1978 Increase Over 1977 Dollars	1978 Increase Over 1977 %
Other	$ 786	$1,600	$3,197				
Borrowed	888	2,111	4,307				
Income tax credits included in borrowed	(426)						
Total	$1,248	$3,711	$7,504	$2,463	197.4%	$3,793	102.2%

AFUDC increased in 1977 over 1976, due primarily to increased construction expenditures associated with the Palo Verde Station. AFUDC increased in 1978 over 1977 due to increased expenditures on the Palo Verde Station, as well as increased AFUDC rates. In 1978, the Company changed its accrued rate from 7½% to 9½% effective January 1, 1978.

AFUDC amounted to approximately 40% and 56% of net income applicable to common stock during 1977 and 1978, respectively.

Other Income

Following is a summary of the changes in other income amounts, excluding AFUDC, for the years ended December 31, 1978 and 1977 (In thousands):

	1976	1977	1978	1977 Increase Over 1976 Dollars	1977 Increase Over 1976 %	1978 Increase Over 1977 Dollars	1978 Increase Over 1977 %
Total other income	$52	$89	$491	$37	71.2%	$402	451.7%

Other income, excluding AFUDC, increased primarily as a result of fluctuations in interest income.

Interest Charges

Following is a summary of changes in interest charges, excluding AFUDC, for the years ended December 31, 1978 and 1977 (In thousands):

	1976	1977	1978	1977 Increase Over 1976 Dollars	1977 Increase Over 1976 %	1978 Increase Over 1977 Dollars	1978 Increase Over 1977 %
Long-term debt	$6,719	$8,161	$ 9,477	$1,442		$1,316	
Other	1,611	1,554	2,943	(57)		1,389	
	$8,330	$9,715	$12,420	$1,385	16.6%	$2,705	27.8%

Interest on long-term debt increased for each year due to the issuance of additional first mortgage bonds during the periods. Other interest changes principally reflect increased borrowings and interest rates in 1978.

Earnings Per Share

Following is a summary of changes in earnings per share for the years ended December 31, 1978 and 1977:

	1976	1977	1978	1977 (Decrease) Over 1976 Dollars	1977 (Decrease) Over 1976 %	1978 Increase Over 1977 Dollars	1978 Increase Over 1977 %
Earnings per share	$1.29	$1.11	$1.30	($.18)	(14.0%)	$.19	17.1%

These earnings are the result of changes in net income, increases in preferred dividend requirements, and increases in common shares outstanding during the periods. Following is a summary of these changes (In thousands):

	1976	1977	1978	1977 (Decrease) Over 1976 Dollars	1977 (Decrease) Over 1976 %	1978 Increase Over 1977 Dollars	1978 Increase Over 1977 %
Net Income	$11,516	$11,422	$16,024	($ 94)	(.8%)	$4,602	40.3%
Preferred dividend requirements	$ 1,481	$ 2,037	$ 2,575	$556	37.5%	$ 538	26.4%
Weighted average number of common shares outstanding	7,800	8,488	10,333	688	8.8%	1,845	21.7%

Corporate Information

Annual Meeting of Shareholders

All Shareholders are invited to attend the 1979 Annual Meeting of Shareholders, Monday, May 21, 1979, 10 a.m. El Paso time, in the Oleander Room of the Rodeway Inn, 6201 Gateway West, El Paso.

Proxies for the meeting will be solicited by the management in a communication to be mailed in early April. This Annual Report is not a part of such proxy solicitation and is not intended to be used as such.

A copy of the Company's most recent 10-K Report, including the financial statements and schedules thereto, filed by El Paso Electric Company with the Securities and Exchange Commission, will be made available to Shareholders without charge upon written request to:

Theta S. Fields, Secretary
El Paso Electric Company
Post Office Box 982
El Paso, Texas 79960

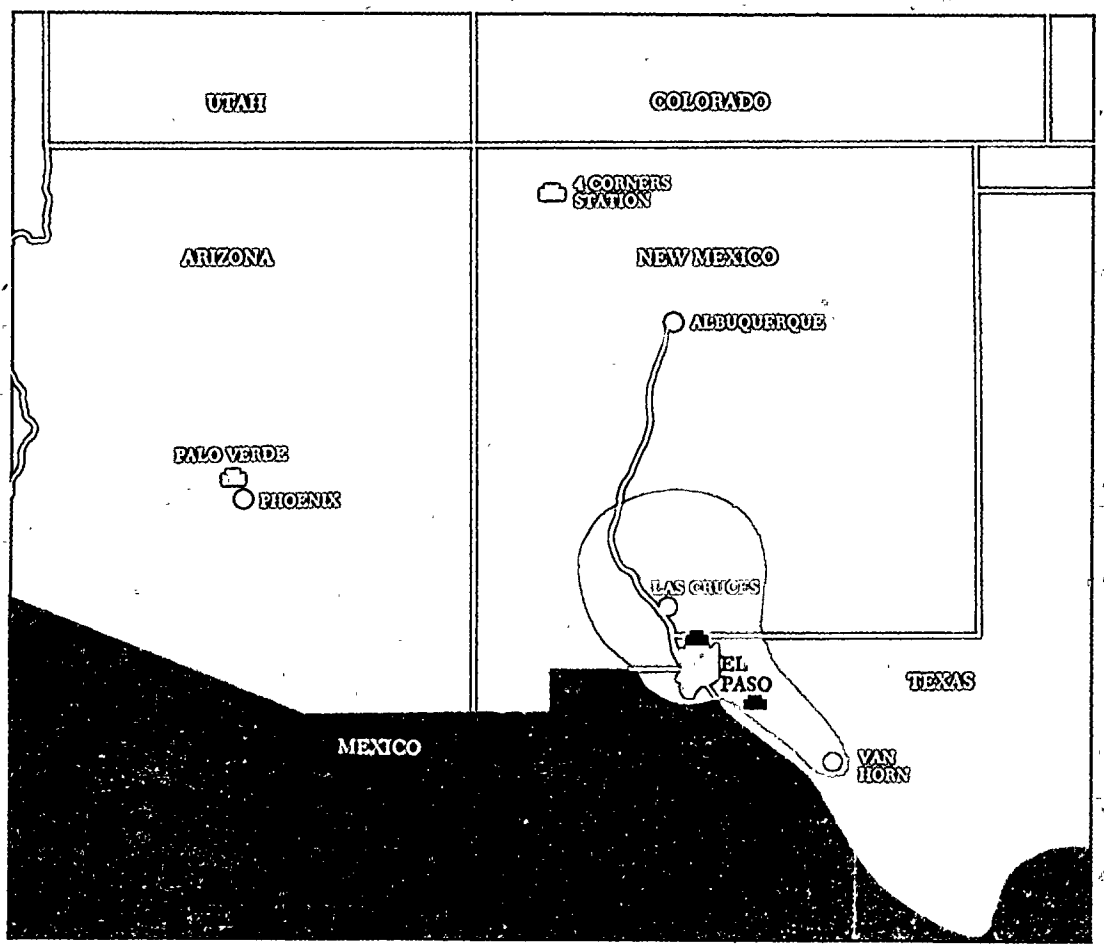
Common Stock Shareholders

The Common Stock of the Company is held in every state of the union, the District of Columbia, some U.S. territories and many foreign countries. The number of shareholders increased from 19,156 in 1977 to 25,633 in 1978. Many of our customers and other persons in the Southwest are shareholders as evidenced by the 5,320 shareholders in Texas and New Mexico who own 21 per cent of the outstanding shares. Our records show that 16,516 shareholders, or 64 per cent, own less than 500 shares each.

Transfer Agents

Irving Trust Company
One Wall Street
New York, New York 10015
(Common and Preferred Stock)

The State National Bank of El Paso
Post Office Box 1072
El Paso, Texas 79958
(Common Stock Only)



Service Area

El Paso Electric is an investor-owned electric utility operating in Texas and New Mexico. The Company is principally engaged in the generation, transmission, distribution and sale of electric energy. El Paso Electric serves approximately 168,000 customers in West Texas and South Central New Mexico in a service area of approximately 10,000 square miles. The service area extends from the Caballo Dam in New Mexico southeasterly to Van Horn, Texas.

El Paso Electric Company
P. O. Box 982
El Paso, Texas 79960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Board of Directors

1. Evern R. Wall°
   President and Chief Executive Officer of the Company (4)

2. Paul Harvey°
   Honorary Chairman of the Board of the Company; Honorary Vice President, El Paso National Bank; Chairman of the Board, First State Bank (38)

3. Dennis H. Lane°
   Former Chairman of the Board of the Company (7)

4. George G. Matkin°
   Chairman of the Board, The State National Bank of El Paso; Chairman of the Board, PanNational Group, Inc. (12)

5. Robert H. Cutler
   Chairman of the Board, Illinois-California Express, Inc. (8)

6. Robert E. Boney°
   Investments, Las Cruces, New Mexico (30)

7. Ben L. Ivey
   Farmer; Director, Chairman of the Board, Bank of Ysleta (9)

8. Dr. Joseph R. Smiley
   President Emeritus, The University of Texas at El Paso; Professor of Modern Languages, U. T. El Paso (10)

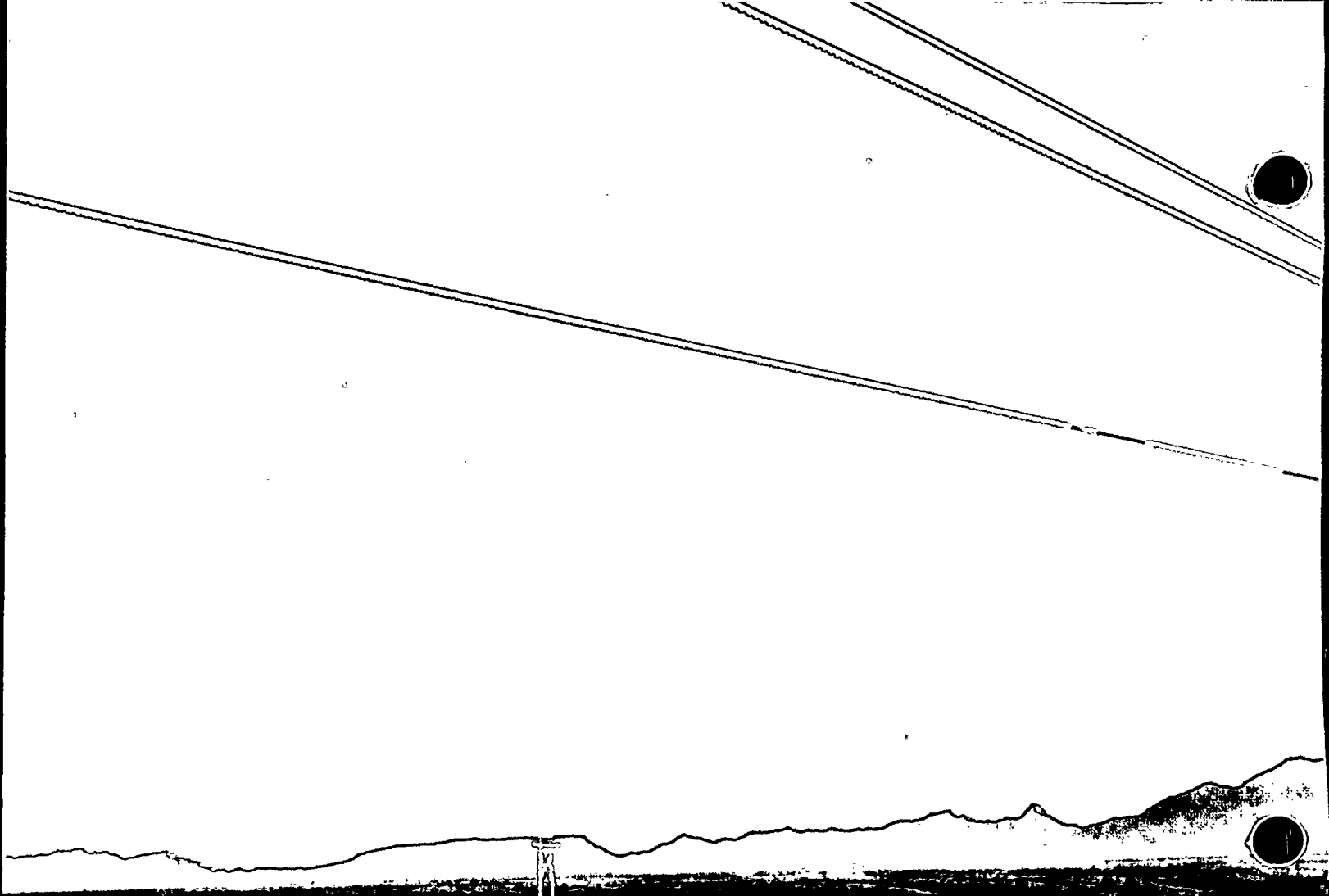
9. Tad R. Smith
   Attorney; Partner, Kemp, Smith, White, Duncan and Hammond; Counsel for the Company (18)

°Members of the Executive Committee

( ) Years of Service on the Board

Officers

Evern R. Wall President and Chief Executive Officer
Rolland E. York Senior Vice President
Billye E. Bostic Senior Vice President
James H. Jones Vice President
Harry I. Zimmer Vice President
Donald G. Isbell Vice President
Charles Mais Vice President
Ralph G. Crocker Treasurer
William J. Johnson Controller
Theta S. Fields Secretary
Robert L. Corbin Assistant Treasurer & Assistant Secretary
Richard E. Farlow Assistant Treasurer
Cecilia R. Shea Assistant Secretary



SECTION 3

GENERAL INFORMATION RESPECTING JOINT APPLICANT PUBLIC SERVICE COMPANY OF NEW MEXICO

(a) Name of joint applicant:

Public Service Company of New Mexico (PNM)

(b) Address of joint applicant:

Post Office Box 2267
Albuquerque, New Mexico 87103

(c) Description of business of joint applicant:

Public Service Company of New Mexico is an electric and water utility engaged in generation, purchase, transmission, distribution and sale of electricity, and the distribution and sale of water in part of the State of New Mexico.

(d) (1) Not applicable.

(d) (2) Not applicable.

(d) (3) (i) State of incorporation and principal location:

PNM is an investor-owned corporation organized and existing under and by virtue of the laws of the State of New Mexico. Its principal offices are in Albuquerque, New Mexico. The cities of Albuquerque, Belen, Bernalillo, Deming, Santa Fe, Las Vegas, and their surrounding areas along with the Western Division make up PNM's seven operating divisions. PNM also provides wholesale electric service to the city of Gallup, City of Farmington, Plains Electric Generation and Transmission Cooperative, Inc., Community Public Service Company, and the United States Department of Energy at Los Alamos, New Mexico.

(d) (3) (ii) Names and citizenship addresses of directors and principal officers:

Directors of Public Service Company of New Mexico

Name	Address
G. A. Schreiber	Chairman of the Board Public Service Company of New Mexico Post Office Box 2267 Albuquerque, New Mexico 87103
J. D. Geist	President Public Service Company of New Mexico Post Office Box 2267 Albuquerque, New Mexico 87103
D. W. Reeves	Chairman of the Executive Committee Public Service Company of New Mexico Post Office Box 2267 Albuquerque, New Mexico 87103
H. L. Galles, Jr.	Galles Chevrolet Company Post Office Box 928 Albuquerque, New Mexico 87103
C. E. Leyendecker	Mimbres Valley Bank Post Office Box 1050 Deming, New Mexico 88030
R. F. Mather	Albuquerque Industrial Development Service, Inc. 401 Second Street, N.W. Albuquerque, New Mexico 87103
R. H. Stephens	Stephens-Irish Agency 526 Sixth Street Las Vegas, New Mexico 87701
R. R. Rehder	University of New Mexico University Hill Albuquerque, New Mexico 87131

E. R. Wood	Santa Fe Motor Company Post Office Box 1947 Santa Fe, New Mexico 87501

Principal Officers of Public Service Company of New Mexico

Name	Address
G. A. Schreiber	Chairman of the Board Post Office Box 2267 Albuquerque, New Mexico 87103
J. D. Geist	President Post Office Box 2267 Albuquerque, New Mexico 87103
R. Mullins	Vice President Post Office Box 2267 Albuquerque, New Mexico 87103
A. J. Robison	Vice President Post Office Box 2267 Albuquerque, New Mexico 87103
J. P. Bundrant	Vice President Post Office Box 2267 Albuquerque, New Mexico 87103
R. F. Mershon	Vice President Post Office Box 2267 Albuquerque, New Mexico 87103
J. B. Mulcock	Vice President Post Office Box 2267 Albuquerque, New Mexico 87103
C. D. Bedford	Vice President Post Office Box 2267 Albuquerque, New Mexico 87103
R. B. Rountree	Senior Vice President Post Office Box 2267 Albuquerque, New Mexico 87103
D. E. Peckham	Secretary and Treasurer Post Office Box 2267 Albuquerque, New Mexico 87103

B. D. Lackey

Controller
Post Office Box 2267
Albuquerque, New Mexico 87103

Each of the directors and principal officers of PNM is a citizen of the United States of America.

(d) (3) (iii) Public Service Company of New Mexico is not owned, controlled, or dominated by an alien, a foreign corporation, or a foreign government.

(d) (4) Public Service Company of New Mexico is not acting as agent or representative of another person in respect of this joint application.

(e) See Section 1 (e) hereof.

(f) In accordance with 10CFR50, Appendix C, a copy of joint applicant Public Service Company of New Mexico's 1978 Financial Report is attached hereto as Appendix 3A.

(g) (Not used)

(h) Not applicable.

(i) The names and addresses of regulatory agencies which have jurisdiction over Public Service Company of New Mexico's rates and services are:

New Mexico Public Service Commission
Bataan Memorial Building
Santa Fe, New Mexico 87503

Federal Energy Regulatory Commission
Washington, D.C. 20426

News publications which circulate in the area in which the facility is located are:

The Arizona Republic
120 East Van Buren
Phoenix, Arizona 85004

The Phoenix Gazette
120 East Van Buren
Phoenix, Arizona 85004

Buckeye Valley News
P. O. Box 217
Buckeye, Arizona 85326

News publications which circulate in Public Service Company of New Mexico's service area include the following:

Las Vegas Daily Optic
Las Vegas, New Mexico 87701

The New Mexican, Inc.
Post Office Box 2048
Santa Fe, New Mexico 87501

Los Alamos Monitor
Post Office Box 899
Los Alamos, New Mexico 87544

Albuquerque Journal
Albuquerque Publishing Company
Post Office Drawer J-T
Albuquerque, New Mexico 87103

Gallup Daily Independent
Post Office Box 1210
Gallup, New Mexico 87301

(j) Not applicable.

APPENDIX 3A

PUBLIC SERVICE COMPANY OF NEW MEXICO
1978 ANNUAL REPORT


Public Service Company of New Mexico

Index — 1978

The annual meeting of stockholders is scheduled to be held April 24, 1979. A proxy form and notice of the annual meeting will be mailed to all stockholders on March 20, 1979.

For further information and details pertaining to the information provided in this report contact D. E. Peckham, Secretary and Treasurer, Public Service Company of New Mexico, Post Office Box 2267, Albuquerque, New Mexico 87103.

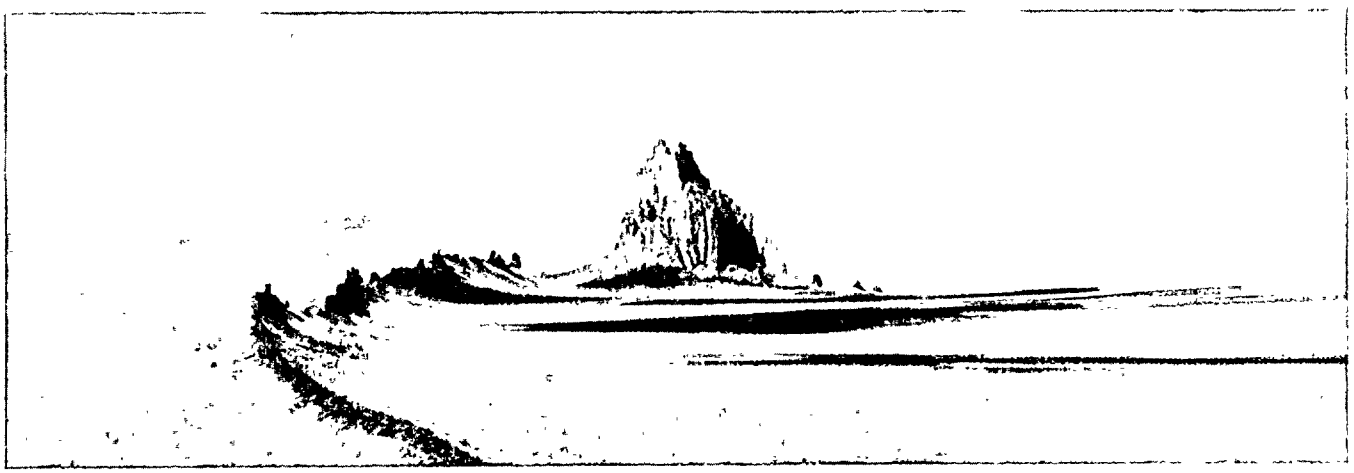
The Common Stock of this Company is traded on the New York Stock Exchange under the symbol PNM.

This Annual Report and the financial statements contained herein are submitted for the general information of the stockholders of the Company and are not intended for use in connection with any sale or purchase of, or any offer or solicitation of offers to buy or sell, any securities of the Company.

COVER PHOTO: Burners in one of PNM's gas- and oil-fired boilers raise the temperature to about 2,700° F. to produce 200,000 pounds of steam per hour.

Financial Highlights

CONDENSED CONSOLIDATED STATEMENT OF EARNINGS	*1978*	*1977*	% *Increase*
Total Operating Revenues	$187,204,899	$138,635,951	35.0
Operating Expenses:			
Operations and Maintenance	103,864,499	76,524,378	35.7
Provision for Depreciation and Amortization	14,450,955	11,463,823	26.1
Taxes, Other than Income Taxes	8,220,733	7,257,043	13.3
Income Taxes	16,721,923	10,986,162	52.2
Total Operating Expenses	143,258,110	106,231,406	34.9
Operating Income	43,946,789	32,404,545	35.6
Net Other Income and Deductions	12,798,279	7,653,033	67.2
Income Before Interest Charges	56,745,068	40,057,578	41.7
Net Interest Charges	19,280,817	15,136,962	27.4
Net Earnings	37,464,251	24,920,616	50.3
Preferred Stock Dividend Requirements	8,383,625	6,284,825	33.4
Net Earnings Applicable to Common Stock	$ 29,080,626	$ 18,635,791	56.1
Average Number of Shares Outstanding	10,288,973	7,569,131	35.9
Per Share Amounts:			
Net Earnings	$ 2.83	$ 2.46	15.0
Dividends	$ 1.72	$ 1.61	6.8
Gross Investment in Property	$879,892,568	$682,058,276	29.0
Kilowatt-hour Sales	4,527,826,227	4,367,003,062	3.7
Peak Load (Kilowatts)	809,000	715,000	13.1



PNM Perspectives—1978

In surveying the number and diversity of problems confronting business in general and electric utilities in particular, it is not difficult to completely overlook the gains that are made. The past decade has seen an unprecedented increase in the dissatisfaction and mistrust toward business on the part of the public. Yet the number of products and the absolute volume of goods and services available to consumers has increased astonishingly. So, why this paradox?

It is no mystery. Inflation is eating away steadily at the core of the American experience. The economy continues to produce, yet the products are held tantalizingly out of the economic reach of many people. People may be making more, but the progressive income tax immediately loots the inflated paychecks. The net result is a gradual decline in purchasing power and a corresponding increase in frustration. Will Americans get used to inflation? Far from it. The resentment is manifesting itself in many ways . . . none of them good. People are reportedly showing great concern regarding their tax burdens, feeling that the system has cheated them out of what was rightfully theirs. The tax man is not the only one suffering from the reaction. Businesses are accused daily of gouging, conniving, and conspiring to cheat the very people who are their own life blood, the consumers. It is an ugly thing, inflation, turning people against one another as little else can. It poses a threat to our nation beside which our other crises pale by comparison.

Nowhere is inflation more evident than in the utility industry. Faced with the task of continuous service, utilities—particularly those in areas of rapid growth—have few of the economic tools at their disposal which might be used to mitigate the effects of inflation. If the service is to be adequate and reliable, the components which go into providing that service must be acquired and put to use when needed . . . not when convenient. As a result, inflationary impacts are translated almost immediately into higher utility rates. This in turn causes understandable frustration, greater mistrust, and dissatisfaction on the part of the consumers.

Sometimes this frustration manifests itself with people joining organizations which purportedly have easy answers. But those who seriously study the problems realize that there are no easy answers and, fortunately, it appears the sincere problem solver is asserting more leadership. Solutions are available but it is going to take courage and persistence to put them in place. Yes, there will always be the demagogues just as there will always be the examples of unscrupulous people in business to whom the demagogues can point. However, even with our problems, the totality of our national moral and social conscience is unsurpassed. No nation supports more charitable causes with more voluntary contributions than does ours, yet it is true that underprivileged persons still exist within our boundaries. Therefore, we can't claim perfection nor utopia but the important point is that more and more persons are realizing that accusations and innuendos will not help us reach our goals as quickly as will some understanding, mutual respect and good old hard work.

As a utility in New Mexico, PNM has certainly been in a position to experience all of the above scenarios. The National Energy Act has as its foundation the increased use of coal and nuclear power. Inasmuch as a significant amount of coal and over 50 percent of the nation's uranium supplies are in PNM's service area, our demand for electric energy has grown at a compound rate of 8.7 percent per year over the last five years. There is no time in memory—if, in fact, such a time ever existed—when such rapid growth had such profound and not altogether beneficial effects. The average cost of our plant and the cost of fuels to generate energy have increased dramatically, causing the cost of our product to increase and add to the frustration level of our customers. We try to communicate our understanding of their frustration and in most instances it has worked.

The facts are that while we have made mistakes, our record is a proud

J. D. Geist
President

one because each year we learn new and better ways to do things. This year we expect to use coal to produce better than 72 percent of PNM's total generation of electricity. Ten years ago, the coal component of our generation mix was negligible by comparison. Cost of Service Indexing, reviewed and again approved by the New Mexico Public Service Commission, has saved millions of dollars in the costs associated with PNM's enormous financing program. Presuming a satisfactory final order from the New Mexico Public Service Commission, in coming years it is expected to save millions more.

Sophisticated data processing systems are extending our employees' capacity to get work done in ways that were unheard of ten years ago. Intra-utility planning is paying off in large savings on the cost of necessary generation and transmission facilities. Employees are better educated and constantly devising better ways to perform tasks to serve the customers.

The world is changing and the industry is changing. We see it every day. And every day this performance refutes those who express the opinion that all things would be better if we only stopped evolving as a society.

We, in New Mexico, like to think that we are a microcosm of the United

States, and this fact is borne out somewhat by the fact that since statehood, we had always voted for the winning presidential candidate until 1976 when we missed by less than ½ of 1 percent of the votes. Therefore, we have some in our state who question the safety of nuclear power, the need for additional power, the utilities' rate design, etc., but PNM has strived to work with our customers and our leaders to reach a resolution of the most pressing problems which affect how well we can do our job.

This annual report notes our problems and shortcomings, but it is, on balance, also a record of our successes to the benefit of our customers who continue to enjoy adequate, reliable, and efficient service and to the credit of our investors whose confidence in us and the future makes this task possible.

Your Company's ability to accomplish this job rests on the tremendous capability and dedication of your employees and officers, the loyalty of our shareholders, and the support and wisdom of your Board of Directors. To each we extend our grateful thanks.

J. D. Geist
President

G. A. Schreiber
Chairman of the Board

The Economic Picture

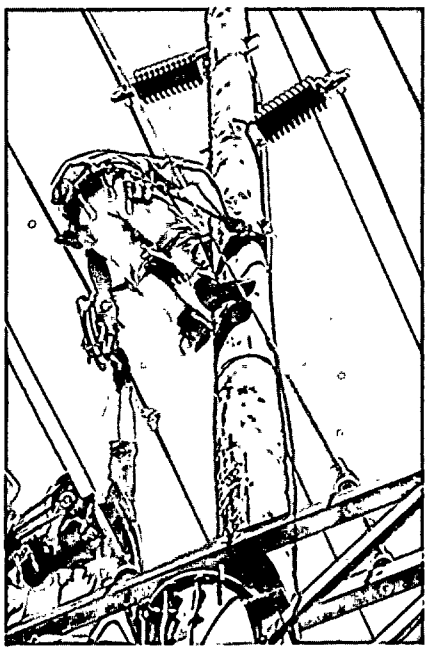
Revenues

As New Mexico grows, the need for power grows. In meeting the increased needs from year to year, PNM revenues continue to climb. However, the inflation which continues to distort all economic pictures has a pronounced impact on PNM revenues as well. Increased sales and improved efficiencies are a large part of the picture, to be sure. Total kilowatt-hour sales in 1978 eclipsed the 1977 total by 160,823,165 to 4,527,826,227 kWhr. Keeping sales climbing as the peak load increases is essential to protect the balance between capacity and demand. Revenues from PNM water operations also climbed from $3,611,626 in 1977 to $4,604,526 in 1978.

In 1978, net earnings amounted to $37,464,251, or a 50.3 percent increase over 1977.

Many factors in addition to increased sales played a part in the revenue picture. Fuel adjustments which allowed the Company to recover cost increases in fuel incurred since the fuel costs were established in the 1973 base rates amounted to $37.7 million in 1978. This revenue flows directly to pay for fuel.

Rate increases in several customer classifications contributed to the overall revenue picture with most of those increases being collected through the Cost of Service Indexing system. In 1978, the Indexing adjustment accounted for $36.8 million. Wholesale rates granted in 1977 for certain large customers accounted for about $26.9 million in 1978; $6.7 million of this amount is subject to refund under the ruling of the Federal Energy Regulatory Commission.



On-going preventative maintenance helps insure reliable service now and in the future.

While per capita consumption decreased in 1978, the increase in the number of customers resulted in the 3.7 percent increase in overall kilowatt-hour sales. But, it is important to remember that sales in 1977 surpassed those in 1976 by over 21 percent, putting the 1978 total almost 26 percent ahead of that reached only two years ago.

Expenses

Purchased power expenses increased from $1.8 million in 1977 to $22.8 million in 1978. Reduced generation capacity was the chief reason for this increase—San Juan Unit 2 was out of service for five months of 1978 due to the 1977 boiler explosion, and power from Four Corners Generating Station was reduced during the year. Additionally, the Company cut back on gas- and oil-generation whenever cheaper energy was available.

Rapidly increasing fuel costs across the board contributed to the increased operating expenses as well. Increased labor costs and additional manning requirements along with general inflationary pressures pushed expenses up in 1978. It is hoped that some of these factors will stabilize in 1979 and in subsequent years.

The value of the equipment needed to provide service and comply with environmental regulations increased the gross investment in property by 29 percent in 1978. A major portion of this increase is in the $60 million PNM has invested in the $120 million sulfur dioxide removal system placed in operation at the San Juan Generating Station. This equipment was put in service in April 1978, and controls the sulfur emission on Units 1 and 2.

Financing

During the five years through 1978, PNM incurred $622 million of capital expenditures, including $219 million in 1978, $150 million in 1977, and $132 million in 1976. The last five years' capital expenditures equal more than 80 percent of the Company's 1978 capitalization. Even with the significant growth in capitalization over this period, the 1978 financing represented

a major undertaking relative to PNM's size. New external funding for 1978 included $65 million in First Mortgage Bonds, $26 million in Preferred Stock, two issues of Common Stock amounting to about $72 million, and $125 million in Pollution Control Bonds. The $125 million issued by the City of Farmington provides funds for construction of pollution control facilities for PNM's share of the San Juan Generating Station and was the largest issue of its kind.

Total new external funding acquired during 1978 including $125 million in pollution control revenue bonds was about $288 million, or an amount equal to almost 56 percent of PNM's year-end 1977 capitalization of $516 million.

A major concern among utility investors today is the impact of rising capital costs combined with the utility industry's increasingly larger external capital requirements. While PNM's total capitalization has increased significantly during 1978, its embedded or composite cost of capital has remained almost identical (10.132 percent for December 31, 1977 versus 10.213 percent for December 31, 1978). PNM's embedded capital costs are not increasing nearly as rapidly as one would imagine because a significant portion of the Company's expansion program is now being funded with lower-cost pollution control revenue bonds. Of the total increase in debt capitalization in 1978 of $111.4 million, about 44 percent, or $48.8 million, came from pollution control revenue bonds.

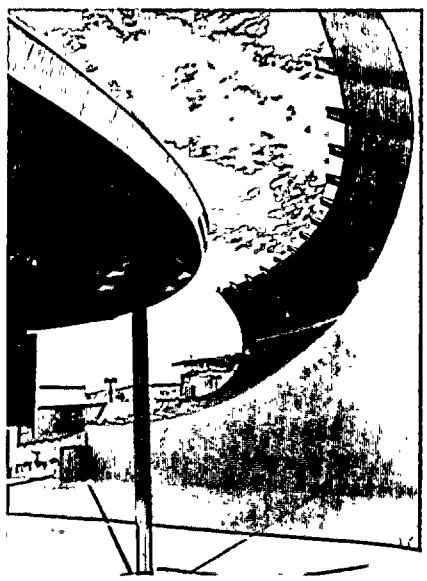
Given PNM's relative size, market conditions, and the general financial health and posture of the utility industry, PNM's management feels that the Company has concluded a successful year of financing in terms of the amount of capital raised and the cost of that capital.

EPA Regional Administrator Adlene Harrison told newsmen it "is a real pleasure to look at your sky" during dedication of the San Juan Plant's $120 million sulfur dioxide scrubbers.

The Company

Service Areas

As New Mexico's major electric utility, PNM provides service to over 195,000 homes, businesses, and factories. The largest percentage of customers, by far, live in or near Albuquerque. The metropolitan area of Albuquerque has an estimated population of 410,000. The Company also serves customers in Santa Fe, the state capital; Las Vegas in north-central New Mexico; Deming, just 30 miles north of the Mexican border; Bernalillo to the north of Albuquerque; and Belen which is just south of Albuquerque. The combined population residing within PNM's service areas is about 520,000.



The Santa Fe Opera in PNM's Santa Fe Division is world-renowned as the most successful summer opera festival in the United States and is a popular attraction for international performers and spectators alike.

The Company was reorganized into its present form 30 years ago and has paralleled New Mexico's rapid growth in the post World War II era. In 1949, PNM's installed capacity was about 55 megawatts. By 1978, the total had risen to 842 megawatts.

In addition to electric service, PNM provides water service to customers in Santa Fe and Las Vegas. Those water systems were incorporated in the companies which handled electric service earlier in the century and the water operations were transferred to PNM control when the acquisitions were made. In fact, the electric properties in Las Vegas also included streetcar operations and those in the Deming Division were originally connected with the local ice plant.

In Albuquerque, the original PNM provided both gas and electric service. With the passing years, the gas, ice, and streetcar businesses were sold off, leaving the present properties which are predominantly electric, but include the two municipal water systems.

Peak Up — Again

The peak demand on the PNM system for 1978 occurred on July 17 when the combined customer use reached 809 megawatts. This, in spite of a general decline in per capita consumption for the year, still presented PNM with a 13.1 percent increase above the preceding year's peak. In fact, the 1978 peak was equal to the output of over 96 percent of PNM owned generating capacity. This graphically points out the need for PNM's massive construction program as well as other projects which are underway to control peak demands in the future.

San Juan Unit 2 Back in Service

Unit 2, at the San Juan Generating Station, which was put out of commission on July 7, 1977, by a massive explosion in the boiler's firebox, was placed back in service in May 1978. The repairs required an almost complete rebuild of the boiler, much rewiring, and extensive work on the ducts leading to the firebox and from it to the electrostatic precipitators. The explosion's force did considerable damage to the precipitators themselves and much work was required to repair them.

The task was gargantuan, considering the boiler is about the size of a 28-story office building. However, competent crews were able to bring this unit back into service prior to the summer peak of 1978. The cost of repairs for PNM's 50 percent share was more than $17.8 million, with $14 million reimbursed to date by insurors. With Unit 2 back in service, the Company is projecting that coal will account for over 72 percent of all kilowatt-hours generated in 1979. Gas will account for approximately 25 percent and the remainder will be produced by burning oil. This should assist in tempering the impact of rising fuel costs on customer billings since coal is still less than a third of the cost of gas or oil for equivalent power produced. Since fuel accounts for over a fourth of our operating expenses, this cost difference is quite significant.

Industrial Activity Growing in New Mexico

In 1978, activities in PNM's newly created Western Division maintained a high level. The Western Division was created to serve the growing needs of mining and milling operations connected with extractive industries. New Mexico is the nation's largest producer of uranium ore and a major producer of coal, oil and natural gas. With energy self-sufficiency a stated goal of the Carter Administration, New Mexico's vast resources will clearly continue to be developed and play a major role. The electric needs of the industries are quite large as evidenced by the fact that a single large drag line used in surface mining can require from 3 to 5 megawatts for its operation. It comes as a surprise to many visitors to the mines to see an enormous machine trailing a large extension cord, but with petroleum realities, running them on coal-produced electricity makes good sense.

Wholesale Customers

In addition to the customers we serve and bill directly, PNM provides power to many other New Mexicans via wholesale sales to various distribution systems. Among these wholesale customers are the Department of Energy at Los Alamos, Community Public Service Company which serves customers in southern New Mexico, the cities of Gallup and Farmington, and Plains Electric Generation and Transmission Cooperative which serves rural electric cooperatives. In 1978, these customers accounted for 17.8 percent of PNM's electric revenues.

Construction and Forecast

The 29 percent increase in the gross investment of PNM's plant in-service during 1978 indicates the rate at which PNM is expanding to meet growing demands in New Mexico. The bulk of the 1978 expenditures were for the pollution control equipment at San Juan, continued construction on San Juan Units 3 and 4 and the participation in the Palo Verde Nuclear Generating Station in Arizona.

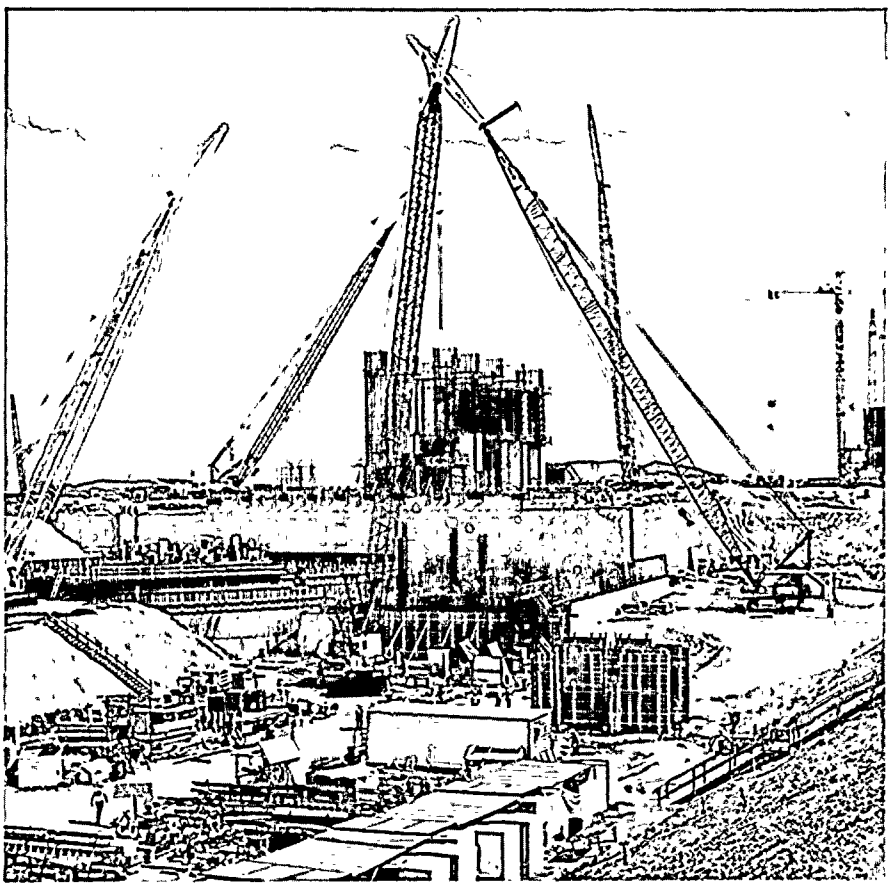
The five-year construction budget, beginning with fiscal year 1979, is estimated to be over $1.2 billion. This expenditure will see the completion of San Juan Unit 3 later this year, the completion of Unit 4 in 1982, and the commercial service of Unit 1 at Palo Verde in May 1982.

Included in this budget are transmission and distribution costs required for system expansion through the next five years.

Current Power Production Facilities

PNM has an installed capacity of 842 megawatts. This capacity is distributed from five plants in our service area and two in northwestern New Mexico near the city of Farmington.

In Albuquerque there are three gas- and oil-fired plants with a combined capacity of 293 megawatts. A small



Crews work toward a 1982 on-line date for the first of three units at the Palo Verde Nuclear Generating Station. PNM is one of several utilities participating in the project near Phoenix, Arizona.

Some 300 PNM employees worked up to 20 hours daily repairing damage at San Juan Unit 2 caused by an electrical fire in cables carrying the unit's start-up power. The unit was back on line only seven days following the October 11 blaze.

steam cycle plant in Santa Fe can produce 11 megawatts and a combustion turbine in Las Vegas is rated at 20 megawatts.

The plants near Farmington are the San Juan Generating Station, which is jointly owned with Tucson Gas & Electric Company (TGE), and the Four Corners Power Plant which is owned by a consortium of six utilities. PNM holds a 13 percent ownership in two 800 megawatt units at this plant. Both San Juan and Four Corners are coal-fired.

San Juan currently has two units in operation and two under construction. PNM's share of the San Juan units and the Four Corners units in operation places the coal-fired capacity of the PNM system at 518 megawatts.

Commission Approves PNM Purchase at San Juan

On January 16, 1979, the New Mexico Public Service Commission approved the sale by TGE to PNM of the TGE interest in Unit 4, now under construction at the San Juan Generating Station. This will allow PNM an additional 236 megawatts upon completion at a cost estimated to be about 80 percent of what the same capacity would cost if the project were begun this year. Consequently, about $50 million has been deleted from the current five-year construction budget.

Thus, when all four units at San Juan are operational, the PNM share of the capacity will amount to 1,016 megawatts. To obtain this power, the four-unit San Juan Station will have already supplied about 70 megawatts to power pollution control equipment.

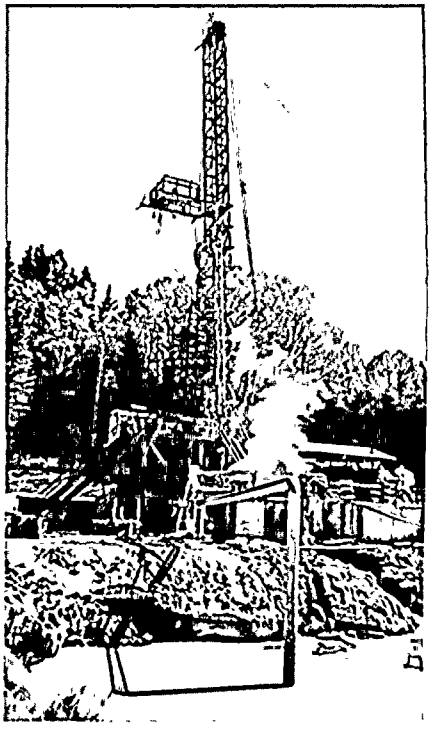
The Company is planning to continue the move away from gas and oil to whatever other energy resources are capable of timely and economical development. This planning began long before the oil embargo and, in spite of rising bills, has saved customers money every day as the prices of gas and oil continue to climb.

The Future

As the political and resource problems of this planet continue to cloud the energy picture in this country, the only certainty is that things will simply have to change. Prior comments on the shift of PNM's generating capacity to coal from natural gas are only part of the changes that are afoot in New Mexico. Considerable work is being done in the attempt to handle the inevitable changes without entirely disrupting our way of life. PNM is at the forefront of seeking new ways to use new resources.

Geothermal

In 1978, the Department of Energy selected the proposal submitted to them by PNM and Union Oil Company to develop the geothermal potential existing in the Jemez Mountains, north of Albuquerque. This project carries great significance because it would be the first major project in this country to use a water-dominated geothermal resource for the production of electricity. This means that the geothermal fluid is mostly water as opposed to the gaseous steam being used in California geothermal/electric generation. The importance lies in the fact that water dominated geothermal resources are found in much greater abundance geologically than the steam variety and if they can be tapped successfully, geothermal potential is greatly increased in the United States.



A test well taps the earth's geothermal heat for fuel to generate electricity at a planned PNM power plant high in the Jemez Mountains of northern New Mexico. The 50 MW plant is expected to be operational in 1982.

The proposal to modify existing gas-fired generating units with solar steam producing equipment has received a lot of interest, but as yet no affirmative decision as far as PNM is concerned. This project is still being pursued as the foremost plan to rapidly put solar generation into the nation's energy mix.

PNM is also actively planning and doing preliminary engineering on a Pumped Storage Generation Project with on-line production slated for the late 1980's. This project involves a recycling hydroelectric system which can be used primarily for peaking power capacity. A reservoir system with a difference in elevation between two reservoirs of approximately 1,300

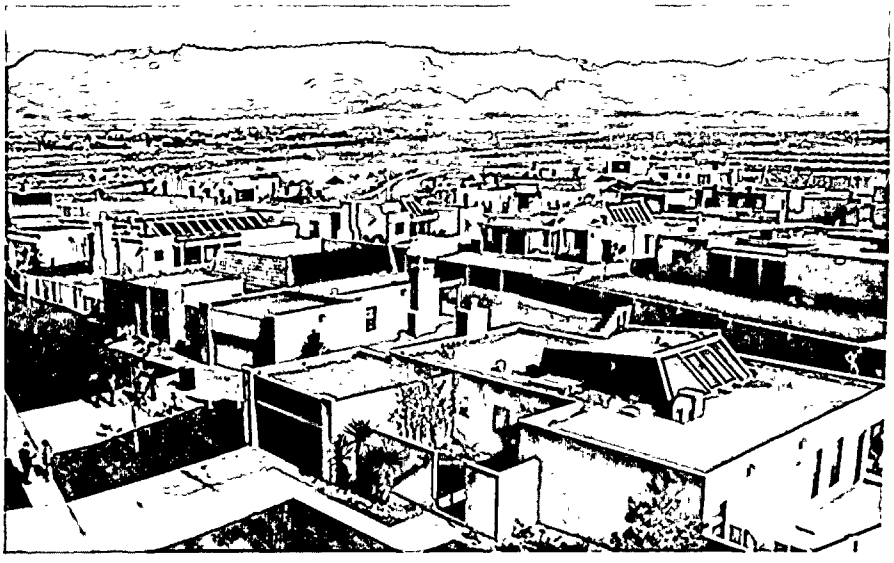
feet, connected by a nearly vertical tunnel, is the basis of the idea. Such systems are in place in several areas of the country. A turbine in the tunnel produces power when the upper reservoir's contents are allowed to flow through it into the lower reservoir. At night, when demand is low, coal and nuclear generated power is used to reverse the turbine and pump the water back into the upper reservoir.

Solar Homes

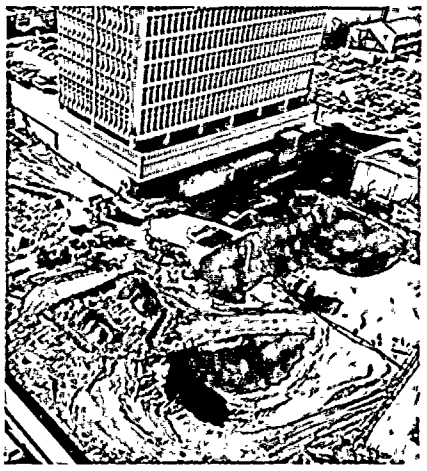
PNM is actively investigating, through several projects involving approximately 30 homes, the potential for solar energy to lower energy and peaking requirements. Such load managed systems could be beneficial to the utility as well as the homeowner by providing the necessary backup on inclement days during off-peak usage times at lower costs, thus charging the thermal storage system which is integrated into all reasonable solar heating arrangements. As one of the two host utilities to the Electric Power Research Institute's $2 million solar heating and cooling project, PNM is in a position to put the data gathered over the course of a three-year study into the most effective use as early as possible. Solar trained staff members are also doing passive solar studies and the Company was awarded an Electric Power Research Institute grant to install load management monitoring equipment on the solar system at the University of New Mexico's planned engineering building.

New PNM Building

PNM's addition to its present headquarters building in Albuquerque will have 5,400 square feet of solar collectors on its south-facing elevation and it is estimated that this solar system will provide nearly 20 percent of the new building's annual energy requirements. Construction on the $18.7 million addition, to be leased from Albuquerque Plaza Associates, began in November 1978 and is slated for completion in 1980. The rapid growth of the Company necessitated this addition as PNM now has personnel located in several buildings in downtown Albuquerque.



PNM is one of two utilities working with the Electric Power Research Institute's $2 million study of various types of solar and electric heating and cooling equipment.



Construction is underway on an eight-floor, 280,000-square foot addition to PNM's headquarters. Needed office space provided by the structure will be partially solar heated.

Other Research

Other research projects aimed at improving the process of mass producing and distributing energy include systems aimed at reducing water consumption at power plants, such as the hybrid wet/dry cooling tower on Unit 3 at San Juan; the world's largest operational regenerative sulfur removal system operating on Units 1 and 2 at San Juan; continuing revegetation studies at mines owned by the Company's subsidiary, Western Coal Co., and numerous other projects.

Plans are still being developed for the installation of another coal-fired plant similar to San Juan in an area south of Farmington known as Bisti. Vast coal deposits in this area lend themselves to use in power production and complement the move toward coal by PNM which agrees with the stated energy policy of the Federal government.

Rates and Regulation

As an electric and water utility operating in New Mexico, PNM is subject to the jurisdiction of the New Mexico Public Service Commission (NMPSC). The NMPSC regulates many facets of the business including rates, service quality, issuance of securities, and generation and transmission construction. The Federal Energy Regulatory Commission (FERC) has jurisdiction over the rates PNM charges for electricity sold for resale and various accounting and reporting procedures.

With regard to electric rates under the jurisdiction of the NMPSC, PNM has been using a method of rate adjustment called Cost of Service Indexing since mid-1975. This method

applied to over 70 percent of PNM sales in 1978.

During 1978, the NMPSC conducted an intensive review of the Indexing process. The Company submitted thousands of pages of documents and testimony to show that Indexing has worked as planned. That is, by offering PNM a more stable return picture, capital costs can be reduced. Since PNM is growing rapidly and the infusion of new capital is making capital costs a larger part of the customer's bill, all savings in capital costs are worth considering as significant.

Basically, Indexing affords a method of adjusting rates with relation to return on common equity. Since common equity is the foundation of PNM financing, such an adjustment protects both the shareholders and customers.

The shareholders have better reason to expect that the allowed rates of return can actually be achieved. This is all but impossible under the traditional method of rate making with its 18-month to two-year lag time. Ratepayers have a more realistic picture of true energy costs sooner, and rapid swings in rates are less likely to occur. In addition, PNM evidence offered during the review estimated capital savings already realized through Indexing to be in a range of $11.5 million to $20.2 million, as calculated through June 1, 1978. Future savings over the next 30 years were estimated to exceed $230 million.

On December 29, 1978, the NMPSC issued an order which recognized that Indexing had met its two primary objectives—attraction of capital and the reduction of the costs of that capital. However, the NMPSC did express some reservations as to whether the quarterly adjustment period in place since 1975 provided the needed incentive to control costs and altered the methodology to establish an annual review and annual adjustment. Additional reporting requirements were also established in this order.

The NMPSC made a difficult regulatory decision to continue a rate making system that is innovative and therefore not fully appreciated by the public who greatly benefits from this system.

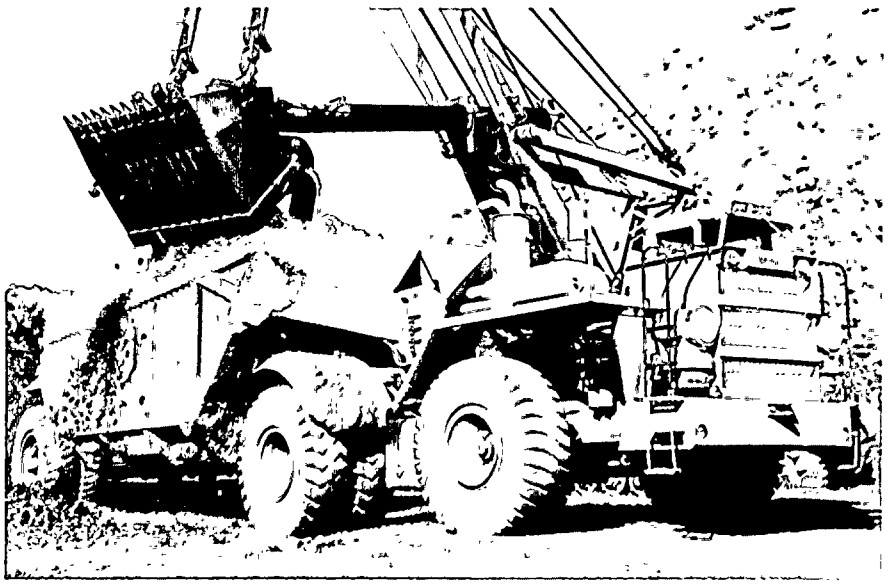
As noted in the revenue section, the Company has a Fuel Adjustment clause which allows the direct pass-through of increased fuel costs. This adjustment is applicable to all sales.

Franchises

As a regulated business, PNM operates under franchise agreements in the areas served. The franchises for electric operations are as follows: Albuquerque, expiration date 1992; Belen, expiration date 1990; Bernalillo, expiration date 1998; Deming, expiration date 1993; Las Vegas, expiration date 1996; Santa Fe, expiration date 1999. The water operation franchise expiration dates are October 31, 1979 and January 1, 1993 for Santa Fe and Las Vegas, respectively. Negotiations are underway with regard to extending the Santa Fe water franchise. A proposed franchise adopted by the city council was defeated in a referendum vote.

Steelworkers wrestle a girder in place high off the ground as construction continues on San Juan Units 3 and 4.

Subsidiaries



Coal needed to keep pace with rising energy demands is loaded onto a belly-dumper near the San Juan plant.

The Company has interest in two subsidiaries, the Public Service Land Company and the Western Coal Co. The Land Company is a wholly owned subsidiary, established to secure water rights and property for the Company's various business-related needs. The foremost of these needs are plant sites and water, both for the water systems owned by the Company and for cooling purposes at generating facilities.

Western Coal Co. was formed as Public Service Coal Company to secure coal leases in the 1950's. When TGE agreed to join PNM in developing the San Juan Generating Station, TGE also purchased 50 percent ownership of the coal company which would be supplying fuel to the plant. Thus, the name was changed to Western Coal Co.

The rapid growth experienced by PNM in the past several years has caused a tremendous need for additional personnel. These needs have been met, but in turn have created the need for additional space. The new building will provide the needed space in the future. In the meantime, workers are doubling up on space and additional space is being provided as best possible.

The Company's training programs are being upgraded and various methods of integrating interdepartmental training are underway.

Employee Development provides in-house programs for the majority of our personnel. Eleven hundred employees participated in these programs.

One hundred eighty-four employees participated in the Educational Assistance Program in 1978. Sixty-one of these individuals are members of minority groups. The program assists employees who wish to further their education at local schools and universities. Concentration on graduate level programs has taken place with The University of New Mexico, New Mexico Highlands University, University of Colorado Audiovisual Education and Colorado State University Audiovisual Education.

Employee Relations

Our employees are our most important asset. During 1978, an employee consultation service was installed, giving our employees an excellent means to communicate with our management. More employees were hired this year than in any previous year.

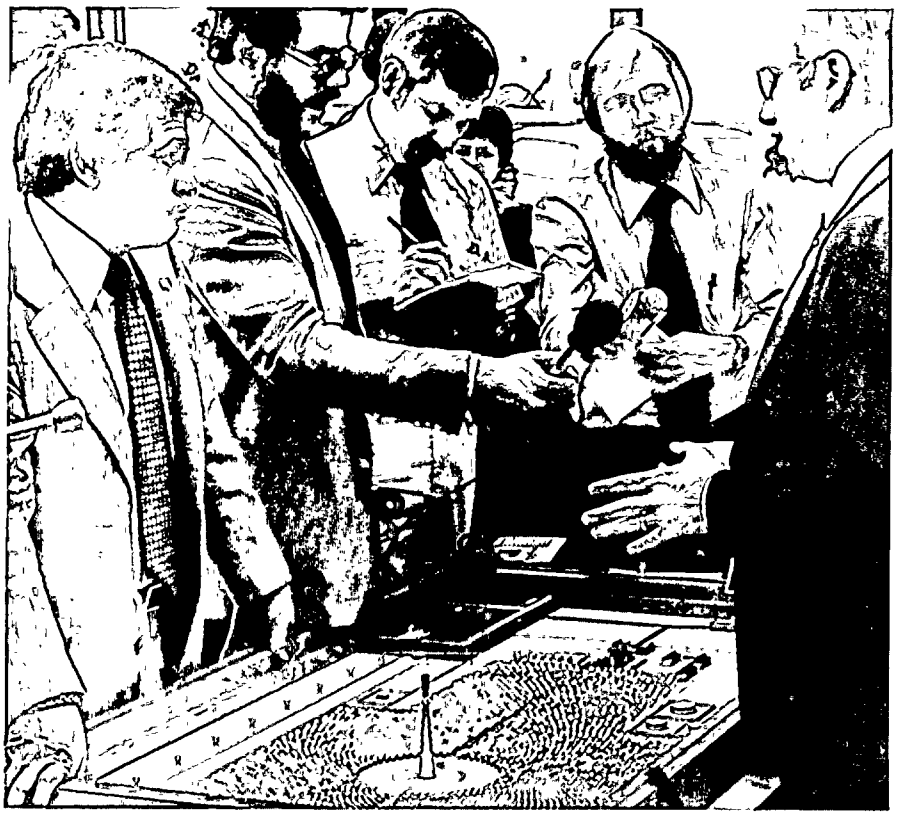
The Company must be competitive in the job market and develop benefits which will retain the skilled and trained employees who make this Company work as well as it does.

Management Changes

During 1978 PNM proved to be very effective in attracting talented and highly skilled new employees. More than 600 people were hired in that 12-month period with almost 300 being additions to the complement as opposed to replacements. Now more than 2,050 employees are working together to provide PNM customers with reliable service today and in the years ahead.

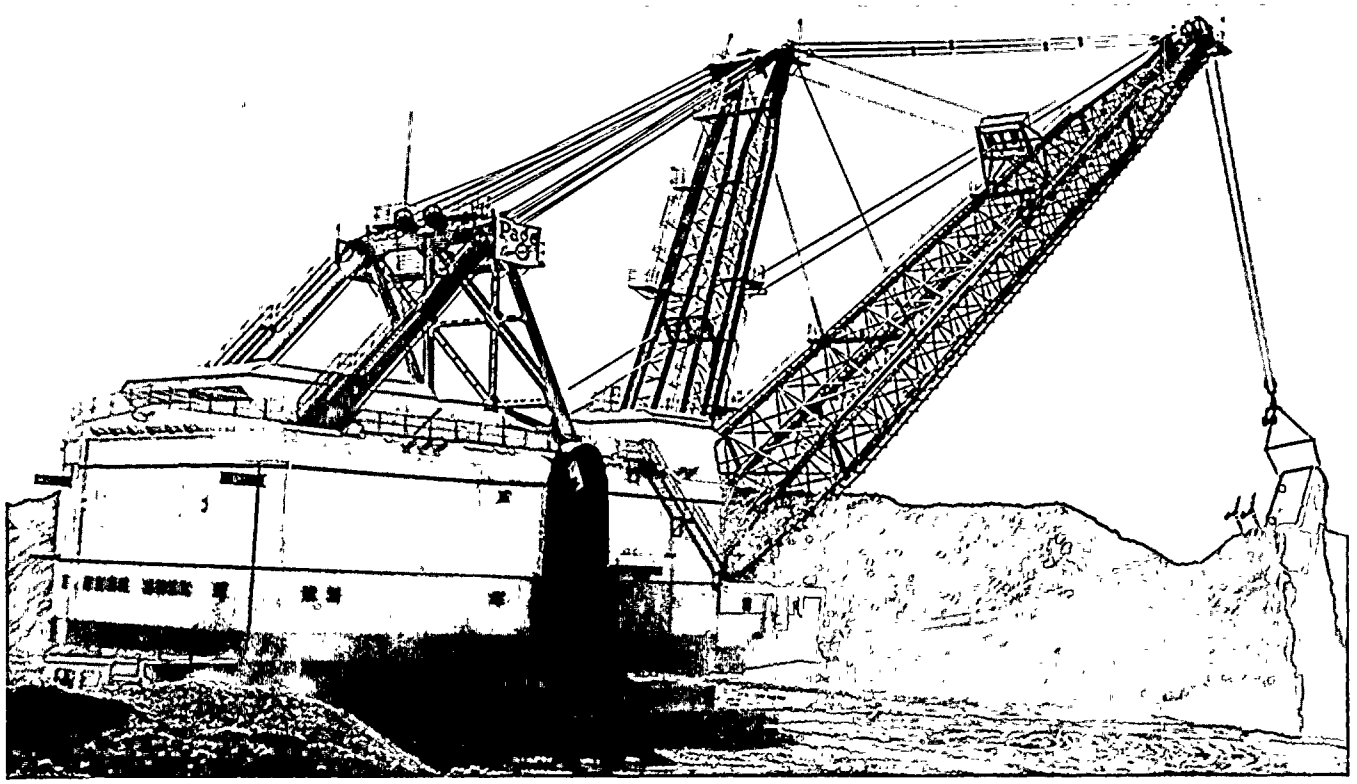
PNM undertook a move to create better internal communications and a more effective distribution of people's talents with an organizational restructuring during the summer of 1978. The restructuring created three districts within the Company, each containing two or more divisions. The Las Vegas and Santa Fe Divisions were combined under direction of District Vice President P. R. Gamertsfelder. The Belen, Bernalillo, and Deming Divisions were placed under supervision of District Vice President R. A. Lake. Albuquerque and Western Division operations were put under direction of District Vice President J. R. Ackerman.

In August 1978, A. J. Robison was promoted to the position of Vice President, Finance. Mr. Robison, who previously was the Company's Assistant Treasurer, assumed expanded duties including financial planning as well as short-term financing.

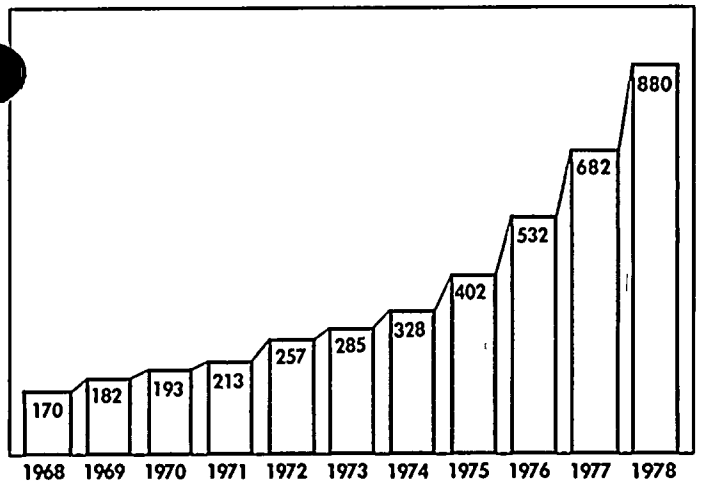


Former Governor Jerry Apodaca listens as PNM President Jerry Geist explains to newsmen how the "power tower" concept could use solar energy to produce electricity. PNM engineers are studying the possibility of retrofitting an existing gas-fired power plant to use the sun's energy to heat water to boiler-level temperatures.

Index to Financial Data

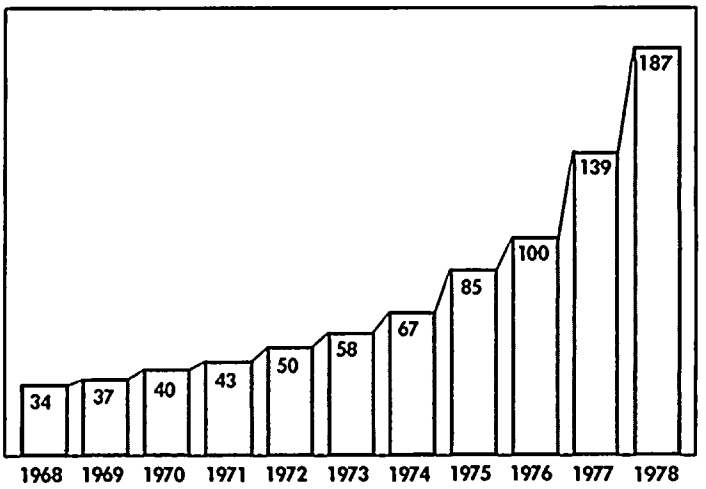


Growth Graphs



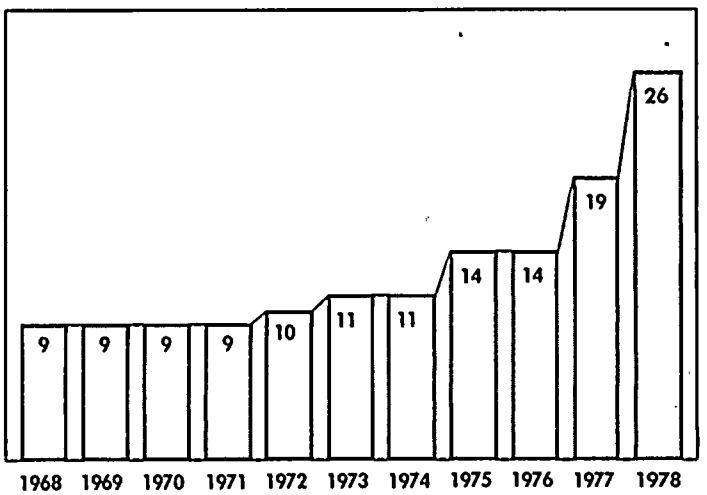
Gross Plant Investment

MILLIONS OF DOLLARS



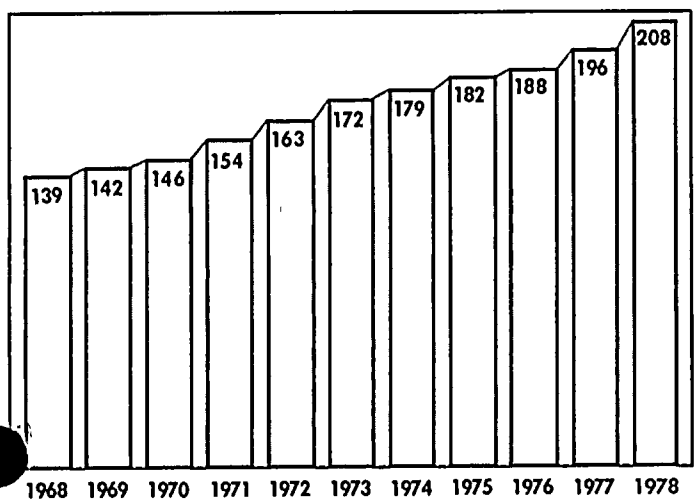
Total Operating Revenues

MILLIONS OF DOLLARS



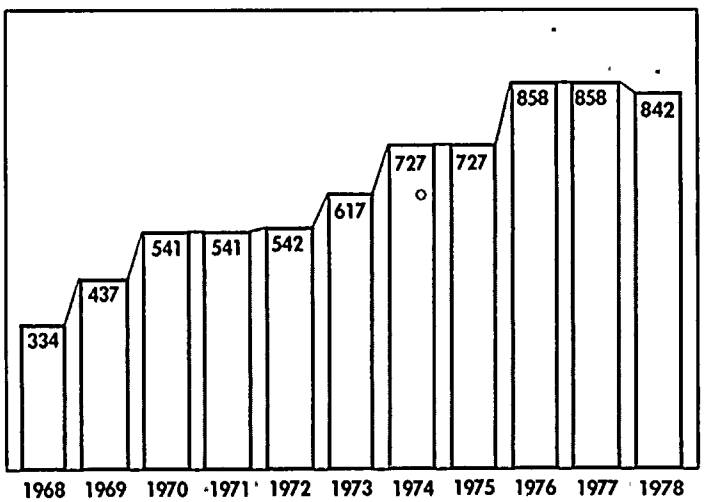
Federal, State, Local and General Taxes

MILLIONS OF DOLLARS



Average Number of Customers Electric and Water

THOUSANDS OF CUSTOMERS



Net Generating Capability

THOUSANDS OF KILOWATTS

Comparative Operating Statistics

	1978	1977	1976	1975
ELECTRIC SERVICE				
ENERGY SALES—kWhr (Thousands)				
Residential	1,000,564	957,390	916,748	875,361
Commercial	1,353,805	1,320,651	1,277,025	1,177,953
Industrial	797,314	686,845	605,559	530,188
Other ultimate customers	164,901	160,922	157,694	136,136
Total sales to ultimate customers	3,316,584	3,125,808	2,957,026	2,719,638
Sales for resale	1,211,242	1,241,195	638,207	578,037
Total energy sales	4,527,826	4,367,003	3,595,233	3,297,675
ELECTRIC REVENUES (Thousands)				
Residential	$ 51,414	$ 39,547	$ 32,423	$ 28,912
Commercial	60,125	45,520	36,198	30,851
Industrial	28,860	18,918	13,070	9,993
Other ultimate customers	7,052	5,215	4,168	3,361
Total revenue from ultimate customers	147,451	109,200	85,859	73,117
Sales for resale	32,568	23,219	9,340	8,241
Total revenue from energy sales	180,019	132,419	95,199	81,358
Miscellaneous electric revenues	2,581	2,605	1,935	1,412
Total electric revenue	$ 182,600	$ 135,024	$ 97,134	$ 82,770
CUSTOMERS AT YEAR END				
Residential	175,439	164,803	156,116	151,111
Commercial	19,496	18,374	17,483	16,738(2)
Industrial	482	493	489	515(2)
Other	263	265	250	246
Total ultimate customers	195,680	183,935	174,338	168,610
Sales for resale	5	5	5	4
Total customers	195,685	183,940	174,343	168,614
Reliable net capability — kW	842,000	858,000	858,000	727,000
Coincidental peak demand — kW	809,000	715,000	633,000	586,000
Average fuel cost per million BTU	105.52¢	92.74¢	61.83¢	47.23¢
BTU per kWhr of net generation	10,993	11,004	11,084	10,848
WATER SERVICE				
SALES — Gallons (Thousands)				
Customer sales	2,747,924	2,726,059	2,959,209	2,859,783
Interdepartmental sales	5,198	5,742	4,014	9,195
Total water sales	2,753,122	2,731,801	2,963,223	2,868,978
REVENUES				
Customer sales	$4,598,657	$3,605,984	$2,386,222	$2,204,967
Interdepartmental sales	5,869	5,642	2,580	2,721
Total water sales	$4,604,526	$3,611,626	$2,388,802	$2,207,688
Customers at year end	18,079	17,427	16,838	16,437

(1) Reclassified against expense

(2) Certain customers were reclassified from commercial to industrial during 1975. The reclassification accounted for a change of 220 customers in both categories.

1974	*1973*	*1972*	*1971*	*1970*	*1969*
828,243	786,108	706,973	648,626	583,136	532,200
1,128,576	1,110,147	985,431	885,782	792,376	732,807
549,622	616,405	653,761	618,695	552,118	524,180
137,843	128,171	123,568	116,202	107,598	97,762
2,644,284	2,640,831	2,469,733	2,269,305	2,035,228	1,886,949
250,901	122,656	114,333	106,000	98,026	91,890
2,895,185	2,763,487	2,584,066	2,375,305	2,133,254	1,978,839
$ 23,314	$ 20,552	$ 17,760	$ 15,295	$ 13,910	$ 12,861
25,403	22,283	19,421	16,309	14,784	13,719
8,349	7,210	7,229	6,549	5,963	5,662
3,004	2,613	2,204	1,994	2,056	1,889
60,070	52,658	46,614	40,147	36,713	34,131
2,782	1,074	937	857	778	659
62,852	53,732	47,551	41,004	37,491	34,790
2,406	2,803	795	670	621	654
$ 65,258	$ 56,535	$ 48,346	$ 41,674	$ 38,112	$ 35,444
147,516	143,201	136,515	127,911	120,865	115,595
16,469	16,241	15,754	14,775	13,908	13,395
298	295	303	308	300	290
231	229	221	205	201	199
164,514	159,966	152,793	143,199	135,274	129,479
4	3	3	3	3	2
164,518	159,969	152,796	143,202	135,277	129,481
727,000	617,000	542,000	540,700	540,700	437,400
583,400	533,000	491,700	458,700	400,600	372,300
39.49¢	26.16¢	24.47¢	23.55¢	23.04¢	24.48¢
11,054	11,017	10,841	10,870	11,058	11,552
3,013,508	2,855,673	2,781,854	2,563,745	2,564,580	2,397,078
12,568	10,710	3,638	1,707	1,782	1,609
3,026,076	2,866,383	2,785,492	2,565,452	2,566,362	2,398,687
$2,103,169	$1,566,730	$1,530,012	$1,434,685	$1,417,697	$1,209,617
5,970	3,585	(1)	813	899	780
$2,109,139	$1,570,315	$1,530,012	$1,435,498	$1,418,596	$1,210,397
16,158	15,848	15,454	15,024	14,495	14,216

Summary of Operations

	1978	1977	1976	1975	1974
Total operating revenues	$187,204,899	$138,635,951	$99,523,146	$84,977,929	$67,367,044
Operating expenses:					
Operations and maintenance	103,864,499	76,524,378	51,535,167	39,784,697	30,836,104
Provision for depreciation and amortization	14,450,955	11,463,823	9,548,173	8,649,772	7,974,988
Taxes, other than income taxes	8,220,733	7,257,043	5,874,485	5,114,600	4,451,727
Income taxes	16,721,923	10,986,162	8,028,464	8,626,084	6,638,499
Total operating expenses	143,258,110	106,231,406	74,986,289	62,175,153	49,901,318
Operating income	43,946,789	32,404,545	24,536,857	22,802,776	17,465,726
Allowance for equity funds used during construction	10,540,694	6,218,281	4,109,043	1,582,648	431,792
Other income and deductions, net	2,257,585	1,434,752	688,681	530,404	454,396
Income before interest charges	56,745,068	40,057,578	29,334,581	24,915,828	18,351,914
Net interest charges	19,280,817	15,136,962	11,977,418	10,699,656	8,059,394
Net earnings	37,464,251	24,920,616	17,357,163	14,216,172	10,292,520
Preferred stock dividend requirements	8,383,625	6,284,825	4,194,268	2,952,133	1,768,400
Net earnings applicable to common stock	$ 29,080,626	$ 18,635,791	$13,162,895	$11,264,039	$ 8,524,120
Average number of shares outstanding	10,288,973	7,569,131	6,106,015	4,608,773	4,370,919
Per share amounts:					
Net earnings	$ 2.83	$ 2.46	$ 2.16	$ 2.44	$ 1.95
Dividends	$ 1.72	$ 1.61	$ 1.42	$ 1.26	$ 1.20

Management's Discussion and Analysis of the Summary of Operations

The following factors, which may not be indicative of future operations or earnings, have had a significant effect upon the Company's results of operations during the years 1977 and 1978.

Electric revenues increased $37.9 million in 1977 and $47.6 million in 1978. The principal factors causing these increases were:

(a) Fuel cost adjustment—natural gas fuel costs and cost of coal per ton have accelerated rapidly, and the shutdown of the first unit of the San Juan Generating Station described below resulted in a larger portion of the Company's system requirements being met through generation at gas-fired plants and through purchases from other utilities. Generally, such costs are passed on to customers, and revenue from the fuel cost adjustment increased $12.1 million in 1977 and $12.9 million in 1978.

(b) Rate increases—the Company bills most customers under a Cost of Service Index order which provides for quarterly adjustments to rates based upon the jurisdictional return on common equity. The Company had revenues of $16.8 million in 1977 and $36.8 million in 1978 from Index adjustments. The Company has periodically negotiated higher rates with certain customers whose rates are subject to the jurisdiction of the FERC. In 1977, new rates for time-of-day customers were filed with the FERC and accounted for $1.7 million of revenues in 1977 and $6.7 million in 1978 which are subject to refund pending a determination by the FERC.

(c) kWhr sales—the number of customers increased in each period and the average use per customer increased in 1977 but decreased in 1978, reflecting to a minor extent the conservation of electricity by the Company's customers. Increases in kWhr sales were 21.5% in 1977 and 3.7% in 1978.

Water revenues increased $1.2 million in 1977 and $1.0 million in 1978 as a result of rate increases allowed by the New Mexico Public Service Commission (the "Commission").

Operating and general expenses increased by $23.0 million in 1977 and $24.3 million in 1978. Principal causes were:

(a) Production of energy from the Company's own generating units increased 26.2% in 1977, due primarily to the second San Juan generating unit being declared operational in December, 1976. The growth in kWhr sales and the boiler explosion causing the shutdown of the first unit at the San Juan generating plant in July, 1977 resulted in the Company being a net purchaser of 51 million kWhr for 1977. Production of energy from the Company's own generating units decreased by 14.3% and the Company was a net purchaser of 957 million kWhr for 1978, due primarily to the purchase of lower-cost energy on the interchange market rather than generating from the Company's gas and oil fired units. Increased fuel and purchased power expenses resulting from the boiler explosion, based upon a formula proposed to the Commission and partially approved by the Commission in an order dated April 12, 1978 (the "Order"), were approximately $4.5 million through December 31, 1977 and $6.9 million for the entire period of the outage. The increased expenses incurred prior to April 12, 1978 were passed on to customers through the fuel adjustment clause by approval of the Commission. However, the Commission ordered that the Company not recover through the fuel adjustment clause any additional incremental purchased power and fuel costs incurred as a result of the boiler explosion, effective as of the date of the Order. The Commission repeated a prior ruling that charges for such increased costs collected prior to the date of the Order are subject to refund if it is determined that the Company was responsible for the explosion. The Commission also stated that should it be ultimately determined that the costs not allowed to be passed on to the customers through the fuel adjustment clause after April 12 should be borne by the Company's customers, then the Commission would allow such costs to be recovered by the Company at a later date. Such costs incurred after April 12 were approximately $337,000.

(b) Rapidly accelerating fuel costs.

(c) Higher costs of labor and related benefits due to escalating wage rates and an increase in the number of employees necessary to operate the expanded electric generating and water facilities.

(d) General inflationary factors.

Maintenance and repair expenses increased by $2.0 million in 1977 and $3.0 million in 1978. Overhauls and inspections at the Las Vegas turbine in 1977, at Person Station in 1978 and at the Four Corners plant and the San Juan plant in 1977 and 1978 accounted for increased costs of $1.7 million in 1977 and $2.4 million in 1978.

The Company's gross utility plant increased by approximately 28% in 1977 and 29% in 1978 as a result of expanded operations, the need to maintain reliable service and increasing environmental protection requirements. This increase in utility plant and the Company's construction program have been the primary causes of increases experienced in the following areas of operations:

(a) Depreciation and amortization.

(b) Taxes, other than income taxes—increases in ad valorem taxes resulted from increased plant.

(c) Allowance for funds used during construction—increased construction at the San Juan plant and the Palo Verde Nuclear Generating Station resulted in an increase in AFUDC in 1977 and 1978. The New Mexico Public Service Commission ordered, effective April 22, 1975, that AFUDC be limited to generating plant construction.

(d) Interest charges and preferred dividends—from 1976 through 1978, the Company issued $95 million principal amount of first mortgage bonds, utilized $122 million of proceeds of pollution control revenue bonds and issued $66 million of preferred stock, generally at higher interest and dividend rates than previous issues, and had up to $68.6 million principal amount of short-term debt outstanding.

Net other income and deductions, excluding AFUDC, increased by $.7 million in 1977 and $.8 million in 1978, primarily because the Company's wholly owned subsidiary completed transactions for the sale of certain real estate and for reimbursement of certain Company operating expenses in 1977. The Company's share of earnings of its fifty-percent-owned subsidiary increased approximately $1.0 million in 1978 due to increased coal deliveries to the San Juan plant and an increase in the price per ton delivered.

As a result of items detailed above, earnings before income taxes, income taxes, net earnings and earnings per share of common stock all increased in 1977 and 1978.

Consolidated Balance Sheet

December 31, 1978 and 1977

Assets

	1978	*1977*
Utility plant, at original cost (notes 3, 7 and 10):		
Electric plant in service	$462,621,269	$379,811,692
Water plant in service	30,283,693	28,218,610
Common plant in service	14,147,983	12,190,902
	507,052,945	420,221,204
Less accumulated depreciation and amortization	102,032,726	88,284,054
	405,020,219	331,937,150
Construction work in progress	371,753,191	261,837,072
Electric plant held for future use	1,086,432	—
Net utility plant	777,859,842	593,774,222
Other property and investments:		
Non-utility property, at cost, net of accumulated depreciation of $455,628 in 1978 and $353,204 in 1977	9,516,348	9,683,394
Investment in fifty-percent-owned company	3,894,532	2,273,077
Other, at cost	1,746,804	2,745,568
Total other property and investments	15,157,684	14,702,039
Current assets:		
Cash (note 4)	1,929,186	5,637,329
Receivables:		
Customers	18,834,974	14,867,486
Other	18,230,636	7,109,901
Allowance for doubtful receivables	(106,242)	(158,340)
Fuel, materials and supplies, at average cost	16,015,251	14,214,636
Prepaid expenses	1,116,773	1,231,591
Deferred fuel costs	11,874,808	7,128,200
Total current assets	67,895,386	50,030,803
Deferred charges:		
Construction advance (note 10)	17,037,495	—
Unamortized debt expense	5,364,143	3,213,726
Other deferred charges	5,432,823	2,727,924
Total deferred charges	27,834,461	5,941,650
	$888,747,373	$664,448,714

See accompanying notes to consolidated financial statements.

Stockholders' Equity and Liabilities

	1978	*1977*
Stockholders' equity (notes 2 and 10):		
Cumulative preferred stock. Authorized 5,000,000 shares; outstanding 860,000 shares of $100 stated value in 1978 and 600,000 shares in 1977 and 800,000 shares of $25 stated value in 1978 and 1977	$106,000,000	$ 80,000,000
Common stock of $5 par value. Authorized 20,000,000 shares; outstanding 12,642,233 shares in 1978 and 8,857,390 shares in 1977	63,211,165	44,286,950
Additional paid-in capital	145,433,263	90,947,569
Retained earnings	67,644,850	56,212,750
Total stockholders' equity	382,289,278	271,447,269
Long-term debt, less maturities and sinking fund payments due within one year (note 3)	356,347,119	244,720,992
Current liabilities:		
Short-term debt (note 4)	23,805,198	50,000,000
Accounts payable	43,071,785	33,195,095
Preferred dividends declared	1,993,850	1,421,850
Sinking fund requirements and maturities of long-term debt (note 3)	1,188,455	1,364,665
Accrued interest	4,423,617	3,591,742
Accrued taxes	7,191,396	4,156,580
Other current liabilities	4,226,327	4,900,941
Total current liabilities	85,900,628	98,630,873
Deferred credits:		
Customer advances for construction	5,603,108	4,883,152
Accumulated deferred investment tax credits (note 5)	36,223,709	25,845,594
Accumulated deferred income taxes (note 5)	17,979,572	16,830,639
Other deferred credits	4,403,959	2,090,195
Total deferred credits	64,210,348	49,649,580
Commitments and contingencies (notes 7, 8, 9 and 10)		
	$888,747,373	$664,448,714

Consolidated Statement of Earnings

Years ended December 31, 1978 and 1977

	1978	1977
Operating revenues:		
Electric (note 9)	$182,600,373	$135,024,325
Water	4,604,526	3,611,626
Total operating revenues	187,204,899	138,635,951
Operating expenses:		
Fuel and purchased power	62,694,589	43,875,773
Other operation expenses	28,002,325	22,528,018
Maintenance and repairs	13,167,585	10,120,587
Provision for depreciation and amortization	14,450,955	11,463,823
Taxes, other than income taxes	8,220,733	7,257,043
Income taxes (note 5)	16,721,923	10,986,162
Total operating expenses	143,258,110	106,231,406
Operating income	43,946,789	32,404,545
Other income and deductions:		
Allowance for equity funds used during construction	10,540,694	6,218,281
Equity in earnings of fifty-percent-owned company, net of taxes (note 5)	1,498,678	486,551
Other, net of taxes (note 5)	758,907	948,201
Net other income and deductions	12,798,279	7,653,033
Income before interest charges	56,745,068	40,057,578
Interest charges:		
Interest on long-term debt	21,349,360	15,294,803
Amortization of debt discount, expense and premium	347,020	239,371
Other interest charges	1,667,452	2,161,477
Allowance for borrowed funds used during construction	(4,083,015)	(2,558,689)
Net interest charges	19,280,817	15,136,962
Net earnings	37,464,251	24,920,616
Preferred stock dividend requirements	8,383,625	6,284,825
Net earnings applicable to common stock	$ 29,080,626	$ 18,635,791
Average number of shares outstanding	10,288,973	7,569,131
Per share amounts:		
Net earnings	$ 2.83	$ 2.46
Dividends	$ 1.72	$ 1.61

See accompanying notes to consolidated financial statements.

Consolidated Statement of Stockholders' Equity

Years ended December 31, 1978 and 1977

	1978	*1977*
Cumulative preferred stock:		
Balance at beginning of year	$ 80,000,000	$ 60,000,000
Issuance of preferred stock	26,000,000	20,000,000
Balance at end of year	106,000,000	80,000,000
Common stock:		
Balance at beginning of year	44,286,950	36,655,760
Issuance of common stock	18,924,215	7,631,190
Balance at end of year	63,211,165	44,286,950
Additional paid-in capital:		
Balance at beginning of year	90,947,569	68,238,436
Premium on common stock issued	57,240,603	24,195,102
Expenses of stock issuance	(2,754,909)	(1,485,969)
Balance at end of year	145,433,263	90,947,569
Retained earnings:		
Balance at beginning of year	56,212,750	49,476,949
Net earnings	37,464,251	24,920,616
	93,677,001	74,397,565
Cash dividends:		
Cumulative preferred stock	8,383,625	6,284,825
Common stock	17,648,526	11,899,990
	26,032,151	18,184,815
Balance at end of year	67,644,850	56,212,750
Total stockholders' equity at end of year	$382,289,278	$271,447,269
Number of shares issued:		
$100 stated value preferred stock	260,000	200,000
Common stock	3,784,843	1,526,238

See accompanying notes to consolidated financial statements.

Consolidated Statement of Changes in Financial Position

Years ended December 31, 1978 and 1977

	1978	1977
Funds provided:		
Net earnings	$ 37,464,251	$ 24,920,616
Charges (credits) to earnings not requiring funds:		
Depreciation and amortization	15,509,718	12,231,798
Provision for noncurrent deferred income taxes, net	1,148,933	(1,907,181)
Investment tax credit, net	10,378,115	10,390,426
Allowance for equity funds used during construction	(10,540,694)	(6,218,281)
Undistributed earnings of fifty-percent-owned company	(1,621,455)	(526,411)
Funds derived from operations	52,338,868	38,890,967
Sale of first mortgage bonds	65,000,000	30,000,000
Sale of preferred stock	26,000,000	20,000,000
Proceeds from pollution control revenue bonds	48,818,288	36,418,069
Sale of common stock	76,164,818	31,826,293
Proceeds from other long-term debt	743,192	2,532,155
Proceeds from short-term debt	142,280,000	158,350,000
Other	4,895,256	2,394,013
	$416,240,422	$320,411,497
Funds used:		
Cash dividends	$ 26,032,151	$ 18,184,815
Utility plant additions	189,307,185	145,189,816
Payment of short-term debt	168,474,802	138,942,000
Reduction of long-term debt	2,304,787	2,574,745
Bond discount and expense	3,161,959	820,362
Capital stock expense	2,754,909	1,485,970
Additions to non-utility property	—	6,497,637
Construction advance	17,037,495	—
Increase in working capital other than short-term debt	4,400,026	2,729,948
Other	2,767,108	3,986,204
	$416,240,422	$320,411,497
Changes in working capital other than short-term debt:		
Increase (decrease) in current assets:		
Cash	$ (3,708,143)	$ 2,581,371
Receivables	15,140,321	4,971,936
Fuel, materials and supplies	1,800,615	5,050,084
Prepaid expenses	(114,818)	443,381
Deferred fuel costs	4,746,608	2,593,479
	17,864,583	15,640,251
Increase (decrease) in current liabilities other than short-term debt:		
Accounts payable	9,876,690	11,717,166
Preferred dividends declared	572,000	424,001
Sinking fund requirements and maturities of long-term debt	(176,210)	(4,504,565)
Accrued interest	831,875	1,564,842
Accrued taxes	3,034,816	1,581,266
Other current liabilities	(674,614)	2,127,593
	13,464,557	12,910,303
Increase in working capital other than short-term debt	$ 4,400,026	$ 2,729,948

See accompanying notes to consolidated financial statements.

December 31, 1978 and 1977

(1) Summary of Significant Accounting Policies

System of Accounts —

The Company maintains its accounting records in accordance with the uniform system of accounts prescribed by the Federal Energy Regulatory Commission (FERC) and adopted by the New Mexico Public Service Commission. As a result, the application of generally accepted accounting principles by the Company differs in certain respects from the application by nonregulated businesses. Such differences generally regard the time at which certain items enter into the determination of net earnings in order to follow the principle of matching costs and revenues.

Principles of Consolidation —

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Public Service Land Company. All significant intercompany transactions have been eliminated.

Utility Plant —

Utility plant is stated at original cost, which includes payroll-related costs such as taxes, pensions and other fringe benefits, administrative costs and an allowance for funds used during construction. Contributions received from customers to meet the customers' special construction requirements are credited to utility plant.

It is Company policy to charge repairs and minor replacements of property to maintenance expense and to charge major replacements to utility plant. Gains or losses resulting from retirements or other dispositions of operating property in the normal course of business are credited or charged to the accumulated provision for depreciation.

Allowance for Funds Used During Construction (AFUDC) —

In accordance with the uniform system of accounts, AFUDC, a noncash income item, is charged to utility plant. The rate used for 1978 and 1977 was 6½% as approved by the New Mexico Public Service Commission. The Commission also ordered, effective April 22, 1975, that AFUDC be limited to generating plant construction. The allowance for equity funds used during construction is credited to other income and deductions and the allowance for borrowed funds used during construction is credited to interest charges. The allocation of AFUDC between borrowed funds, after taxes, and equity funds is based on the method required by the FERC.

Depreciation —

Provision for depreciation of utility plant is made at annual straight-line rates prescribed by the New Mexico Public Service Commission. The average depreciation rates used were as follows:

	1978	*1977*
Electric plant	3.39%	3.09%
Water plant	1.89%	1.89%
Common plant	5.89%	5.15%

The provision for depreciation and amortization of certain equipment, including amortization applicable to capital leases, is charged to clearing accounts along with other costs of operation and subsequently apportioned to operating expenses and property accounts based on the use of the equipment. Depreciation of non-utility property is computed on the straight-line method.

Investment in Fifty-Percent-Owned Company —

The Company's investment in a fifty-percent-owned company is stated at equity. The co-owner, Tucson Gas & Electric Company, is participating with the Company in the construction and operation of a steam turbo-electric generating plant described in note (7). The generating plant utilizes coal from properties of the fifty-percent-owned company as a source of fuel.

Deferred Fuel Costs —

The Company uses the deferred method of accounting for the portion of fuel costs which is recoverable in subsequent periods under fuel adjustment clauses.

Amortization of Debt Discount, Expense and Premium —

Discount, expense and premium incurred in the issuance of the presently outstanding debt are being amortized by charges to income over the lives of the respective issues on the debt outstanding method.

Investment Tax Credits —

The Company follows the practice of deferring investment tax credits and amortizes them over the estimated useful lives of the related properties. Investment tax credit carryforwards are recorded to the extent of the sum of the investment tax credits which would have been realized if taxes payable had been based on pretax accounting income adjusted for permanent differences and the existing net deferred tax credits which would reverse during the investment tax credit carryforward period.

Income Taxes —

Certain revenue and expense items in the Consolidated Statement of Earnings are recorded in a year different from the year in which they are recorded for income tax purposes. Deferred income taxes are provided on these timing differences to the extent allowed for rate-making purposes. This normalization method is used primarily for differences attributable to deferred fuel costs and the use of liberalized depreciation methods and different lives under the asset depreciation range (ADR) than under the guideline depreciation provisions. Certain other differences result in a reduction in income tax expense in the current year. This flow-through method is used primarily for differences between tax depreciation computed under the guideline life provisions and book depreciation and certain capitalized construction costs, principally the allowance for funds used during construction, deducted currently for income tax purposes.

At present, rates applicable to certain customers subject to FERC control allow recovery of amounts necessary to provide additional tax normalization of the items described above which are accounted for under the flow-through method for other customers. Provision has been made for additional deferred income taxes attributable to amounts collected under these rates.

Revenues —

Revenues are recognized based on cycle billings rendered to customers monthly. The Company does not accrue revenues for services provided but not billed at the end of a fiscal period.

Segment Information — Major Customers —

The Company's operations are primarily in the electric utility industry. Revenues derived from sales to domestic Federal, state, county and municipal governmental agencies aggregated approximately $37.5 million, or 20.0% of total operating revenues during 1978, and $27.6 million, or 19.9% during 1977.

Pension Plan —

The Company's policy is to fund pension costs which are composed of normal costs and amortization of prior service costs over thirty years.

(2) Stockholders' Equity

The cumulative preferred stock may be redeemed by the Company, upon thirty days notice thereof, at stated redemption prices (plus accrued and unpaid dividends). Information concerning the cumulative preferred stock is as follows:

Series	Stated Value	Shares Outstanding	Aggregate Stated Value	Redemption Price (a)
1965 Series, 4.58%	$100	130,000	$ 13,000,000	$103.032
1974 Series, 9.2% (b)	100	170,000	17,000,000	109.20
1975 Series, 10.12% (b)	100	100,000	10,000,000	110.12
9.16% Series (b)	25	800,000	20,000,000	27.29
8.48% Series (b)	100	200,000	20,000,000	108.48
8.80% Series (b)	100	260,000	26,000,000	108.80
		1,660,000	$106,000,000	

(a) Redemption prices are at reduced premiums in future years.

(b) Redemption may not be made through certain refunding operations prior to April 15, 1979 for the 1974 Series, or prior to March 15, 1980 for the 1975 Series, or prior to June 1, 1981 for the 9.16% Series, or prior to April 1, 1982 for the 8.48% Series, or prior to April 1, 1983 for the 8.80% Series.

The Board of Directors reserved 900,000 shares of unissued common stock for the dividend reinvestment program, the Employee Stock Purchase Plan and the Tax Reduction Act Stock Ownership Plan, of which 588,919 shares remained unissued at December 31, 1978.

Charter provisions relating to the preferred stock and the indenture securing the first mortgage bonds impose certain restrictions upon the payment of cash dividends on common stock of the Company. At December 31, 1978, there were no retained earnings restricted under such provisions.

(3) Long-Term Debt

The details of the Company's outstanding long-term debt including unamortized discount and premium, less sinking fund payments and maturities due within one year, are as follows:

	1978	1977
First Mortgage Bonds:		
3 % Series, due 1980	$ 3,700,000	$ 3,750,000
3¾% Series, due 1982	3,000,000	3,040,000
3⅝% Series, due 1984	2,311,841	2,312,207
4⅜% Series, due 1988	8,690,000	8,792,000
4⅞% Series, due 1991	10,002,000	10,090,000
5⅞% Series, due 1997	18,558,546	18,768,962
7¼% Series, due 1999	14,043,842	14,192,515
8⅛% Series, due 2001	19,165,936	19,363,624
7½% Series, due 2002	19,365,909	19,563,968
9⅛% Series, due 2005	25,000,000	25,000,000
8⅛% Series, due 2007	29,921,494	29,917,831
9 % Series, due 2008	64,368,973	—
1976 Pollution Control Series, securing 6⅞% Pollution Control Revenue Bonds, Series 1976, due 2006 ($20,000,000 principal amount less $400,308 at December 31, 1978 and $1,799,799 at December 31, 1977 held by trustee)	19,599,692	18,200,201
1978 Pollution Control Series, securing 6% Pollution Control Revenue Bonds, Series 1978, due 2008 ($125,000,000 principal amount less $85,424,955 at December 31, 1978 held by trustee)	39,575,045	—
7.6% Pollution Control Revenue Bonds, Series 1974, due 1984	55,000,000	55,000,000
5% Pollution Control Revenue Bonds, 1977 Series A, due 1984 ($22,000,000 principal amount less $7,843,752 at December 31, 1977 held by trustee)	22,000,000	14,156,248
Other	2,043,841	2,573,436
	$356,347,119	$244,720,992

Substantially all utility plant is pledged to secure the first mortgage bonds.

Approximately 25 percent of the original principal amount of each series of first mortgage bonds will be redeemed through sinking fund requirements prior to the aforementioned due dates. The aggregate amounts of maturities and sinking fund requirements on long-term debt outstanding at December 31, 1978 are as follows:

1979	$1,188,455
1980	5,594,681
1981	1,886,817
1982	4,891,341
1983	2,234,025

In August 1977 the City of Farmington, New Mexico issued and sold $77,045,000 principal amount of its 5.9% Pollution Control Revenue Refunding Bonds, Series 1977, the proceeds of which are expected to be used to retire the 7.6% Pollution Control Revenue Bonds and the 5% Pollution Control Revenue Bonds at their maturity in 1984. From and after such retirement, but not before, the Refunding Bonds will be payable out of revenues received by the City from the Company. Upon such retirement the Company will also guarantee the payment of the Series 1977 Bonds and secure its guaranty with an equal principal amount of its first mortgage bonds.

(4) Short-Term Debt and Compensating Balance Arrangements

The Company's interim financing requirements are met through issuance of unsecured notes payable to banks and commercial paper. The Company has agreed to maintain compensating balances with certain lending banks or to pay fees in lieu of such balances. Compensating balances are generally equal to 20% of the outstanding indebtedness or 10% of the lines of credit at such banks, whichever is greater. Details of the Company's short-term debt at December 31, 1978 and December 31, 1977 and for the years then ended were as follows:

	1978	*1977*
Aggregate short-term debt outstanding:		
Notes payable to banks	$ 4,050,198	$19,050,000
Commercial paper	$19,755,000	$30,950,000
Average interest rate on outstanding debt:		
Notes payable to banks	11¼%	7⅞%
Commercial paper	10⅛%	6⅝%
Maximum short-term debt outstanding during year	$68,600,000	$56,120,000
Average short-term debt outstanding during year	$23,028,000	$36,950,000
Weighted average interest rate on short-term debt outstanding during year, computed using daily outstanding balances:		
Stated interest rates	7¾%	6 %
Effective rate considering the effect of compensating balances	8⅛%	6⅛%
Unused lines of credit (subject to cancellation at the banks' option)	$53,120,000	$31,525,000
Compensating balances at end of year	$ 916,000	$ 676,000

Compensating balances have been reduced by the average difference between collected bank balances and book balances.

(5) Income Taxes

Income taxes consist of the following components:

	1978	*1977*
Current Federal income tax	$ 1,609,467	$ 713,123
Current state income tax	1,048,208	647,462
Deferred Federal income tax	2,130,165	(2,314,593)
Deferred state income tax	656,441	503,587
Amount equivalent to current investment tax credit	12,412,588	12,356,854
Amortization of accumulated investment tax credit	(527,353)	(368,463)
Total income taxes	$17,329,516	$11,537,970
Charged to operating expenses	$16,721,923	$10,986,162
Charged to other income and deductions	607,593	551,808
Total income taxes	$17,329,516	$11,537,970

The Company has investment tax credit carryforwards, for tax purposes, of approximately $20,890,000 as of December 31, 1978 which will expire in 1984 and 1985. Of this amount, approximately $13,119,000 has been recorded, for financial statement purposes, as a reduction of deferred Federal income tax credits.

Deferred income taxes result from timing differences in the recognition of income and expenses for tax and accounting purposes. The major sources of these differences and the tax effects of each were as follows:

	1978	*1977*
Deferred fuel costs	$ 2,396,088	$ 1,309,188
Liberalized depreciation methods and asset class lives shorter than guidelines lives	4,375,703	3,557,809
Other miscellaneous items	46,514	362,973
Investment tax credit carryforward	(4,031,699)	(7,040,976)
	$ 2,786,606	$(1,811,006)

The current portion of deferred taxes (included in accrued taxes) results from timing differences on deferred fuel costs. Such balance amounted to $1,976,975 as of December 31, 1978 and $339,302 as of December 31, 1977 after reduction for investment tax credit carryforwards.

The Company's effective income tax rate was less than the Federal income tax statutory rate for each of the years shown. The differences are attributable to the following factors:

	1978	*1977*
Federal income tax statutory rate	48.0%	48.0%
Tax depreciation in excess of book depreciation caused by use of guideline depreciation provisions	(1.2%)	(2.8%)
Allowance for funds used during construction, net of depreciation adjustments	(12.3%)	(11.0%)
Certain employee benefits and taxes capitalized for financial statements, net of depreciation adjustments	(.7%)	(1.3%)
Amortization of investment tax credits	(1.0%)	(1.0%)
Other miscellaneous items	(1.2%)	(.3%)
Company's effective income tax rate	31.6%	31.6%

(6) Pension Plan

The Company has a pension plan covering substantially all of its employees, including officers. The plan provides for monthly pension payments to participating employees upon their attaining the age of 65 or the age of 62 with 30 years service, the amount of such payments being dependent upon length of service and the average wage of the five most highly compensated consecutive years of employment. Early retirement is optional after age 55 or 30 years of service. Normal retirement benefits are the lesser of 65% of the participant's average annual base earnings rate minus $1,320 or 2% of the participant's average annual base earnings rate times his years of credited service. The Company made contributions to the employees' pension plan of $2,807,000 in 1978 and $2,091,000 in 1977 including normal costs and amortization of prior service costs.

Prior to May 1, 1978, the employees contributed $3 for the first $400 of monthly base salary, plus 3 percent of that part of base salary in excess of $400 during each month. The Company's funding of this portion of pension costs after such date will not have a significant effect on net earnings.

As of January 1, 1978, the most recent valuation date, the actuarially computed present value of vested benefits did not exceed the total market value of the pension fund assets and the estimated amount of the unfunded prior service liability was approximately $3,400,000.

(7) Construction Program and Jointly-Owned Plants

The Company is participating with Tucson Gas & Electric Company in the construction of the steam turbo-electric San Juan Generating Station. The Company will own an undivided fifty-percent interest in the first three units of the station. The Company has recently reached an agreement with Tucson to purchase Tucson's fifty-percent undivided interest in the fourth and final unit of the San Juan Station.

The Company is also participating with several other utilities in the construction of the Palo Verde Nuclear Generating Station with the first unit scheduled for completion in 1982.

It is estimated that the Company's construction expenditures for 1979 will approximate $314,000,000 including expenditures on the jointly-owned projects. In connection, therewith, substantial commitments have been made. In addition to such amount, the Company's wholly-owned subsidiary forecasts construction expenditures of approximately $23,000,000.

Details of the Company's interest in jointly-owned plants at December 31, 1978, excluding the purchase of Tucson's share of San Juan Unit 4, were as follows:

	Plant in Service	*Accumulated Depreciation*	*Construction Work in Progress*	*Share of Total Plant*
San Juan Generating Station	$169,279,124	$10,735,731	$230,887,889	50 %
Palo Verde Nuclear Generating Station	—	—	$ 94,256,934	10.2%
Four Corners Generating Station Units 4 and 5	$ 25,922,336	$ 5,787,270	$ 4,688,318	13 %

These amounts represent the Company's share of capital costs and the Company has provided its own financing. The Company's share of direct expenses is included in the corresponding operating expenses in the Consolidated Statement of Earnings. The Company also has undivided interests in transmission facilities which are not significant.

(8) Lease Commitments

The Company leases data processing, communication, office and other equipment, office space, utility poles (joint use) and real estate. Certain leases, primarily for data processing equipment, are capital leases. All other leases are operating leases.

Certain leases provide purchase options in the approximate amount of $2,392,000 for data processing equipment and $531,000 for construction equipment. Renewal options and contingent rental provisions were not significant.

Leased property under capital leases at December 31, 1978 and 1977 was as follows:

	1978	*1977*
Data processing equipment	$2,310,530	$1,653,195
Other	180,657	210,538
	2,491,187	1,863,733
Less accumulated amortization	969,870	651,405
	$1,521,317	$1,212,328

Future minimum lease payments under capital leases at December 31, 1978 were:

1979	$ 517,955
1980	545,139
1981	553,586
1982	478,969
1983	10,440
Later years	240,000
Total minimum lease payments	2,346,089
Less amount representing executory costs	98,479
Net minimum lease payments	2,247,610
Less amount representing interest	553,373
Present value of net minimum lease payments	$1,694,237

Future minimum rental payments required under operating leases that have initial or remaining noncancellable lease terms in excess of one year as of December 31, 1978 were:

1979	$ 615,963
1980	395,354
1981	226,387
1982	147,397
1983	146,750
Later years	501,513
Total minimum payments required	$2,033,364

Rents charged to operating expenses were $1,091,226 in 1978 and $969,919 in 1977. Such amounts exclude payments made on capital leases. Rents charged to utility plant were $576,880 in 1978 and $1,006,126 in 1977.

The Company has entered into an agreement, not included above, for the lease of an office building. Lease payments commencing after construction is completed will be 4.42% of construction costs per year for the first three years and 9.62% per year for the remaining thirty-two years of the initial lease term. Construction costs are now projected to be approximately $18,700,000. Such lease is an operating lease.

(9) Revenues Subject to Refund

On July 7, 1977, a boiler explosion caused the shutdown of Unit 2 at the San Juan generating plant. The Company's portion of the total cost of repairs was approximately $17.8 million. The management of the Company currently believes that most of the cost of repairs will be covered by insurance. The unit was back in operation in May 1978. The major part of increased costs for replacement energy required during the shutdown was, with the approval of the New Mexico Public Service Commission, passed on to customers through the fuel adjustment clause; however, the Commission has ruled that charges for such increased costs are subject to refund if it is determined that the Company was responsible for the explosion. Amounts collected subject to refund, based upon a formula proposed to the Commission, were approximately $2.1 million in 1978 and $4.5 million in 1977. The future effect on net earnings, if any, is not presently determinable.

In addition, wholesale rate increases have been implemented, providing revenues of approximately $6.7 million in 1978 and $1.7 million in 1977 which are subject to refund.

(10) Subsequent Events

On February 1, 1979 the Company sold 400,000 shares of cumulative preferred stock, 8.75% Series, $100 stated value. This series of preferred stock will be subject to a mandatory sinking fund beginning in 1984.

On January 16, 1979 the New Mexico Public Service Commission approved the Company's purchase of the fifty-percent undivided interest of Tucson Gas & Electric Company in San Juan Unit 4 at Tucson's cost to date of purchase, including carrying charges, now estimated to be approximately $61 million. In addition, the Construction advance of approximately $17 million representing Tucson's portion of costs of construction of Unit 4 from August 1, 1978 to December 31, 1978 was advanced by the Company. These amounts will be reflected in the Company's construction work in progress after closing.

(11) Quarterly Results of Operations (Unaudited)

The results of operations by quarters for 1978 and 1977 were as follows:

Quarter Ended	Total Operating Revenues	Operating Income	Net Earnings	Net Earnings per Share
December 31, 1978	$49,473,079	$ 9,547,670	$ 7,780,866	$.45
September 30, 1978	$50,643,032	$13,038,977	$11,725,524	$.90
June 30, 1978	$44,078,886	$11,147,602	$10,005,091	$.84
March 31, 1978	$43,009,902	$10,212,540	$ 7,952,770	$.71
December 31, 1977	$41,208,201	$10,032,865	$ 8,739,356	$.87
September 30, 1977	$36,566,841	$ 8,910,264	$ 6,647,733	$.67
June 30, 1977	$31,317,032	$ 6,913,172	$ 4,803,972	$.42
March 31, 1977	$29,543,877	$ 6,548,244	$ 4,729,555	$.47

In the opinion of management of the Company, all adjustments (consisting of normal recurring accruals) necessary for a fair statement of the results of operations for such periods have been included.

(12) Utility Plant Replacement Cost (Unaudited)

Replacing items of utility plant with assets having equivalent productive capacity generally requires a substantially greater capital investment than was required to purchase the assets which are being replaced. Such additional capital investment reflects the cumulative effect of inflation on the costs of these assets.

The Company's annual report on Form 10-K (a copy of which is available upon request) contains specific information with respect to replacement cost of utility plant in service as of December 31, 1978 and 1977 and the approximate effect which replacement cost would have had on the computation of depreciation for the years then ended.

Accountants' Report

PEAT, MARWICK, MITCHELL & CO.
CERTIFIED PUBLIC ACCOUNTANTS
SUITE 500, FIRST PLAZA
POST OFFICE BOX 1027
ALBUQUERQUE, NEW MEXICO 87103
505-247-4281

The Board of Directors
Public Service Company of New Mexico:

We have examined the consolidated balance sheet of Public Service Company of New Mexico and subsidiary as of December 31, 1978 and 1977 and the related consolidated statements of earnings, stockholders' equity and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned consolidated financial statements present fairly the financial position of Public Service Company of New Mexico and subsidiary at December 31, 1978 and 1977 and the results of their operations and changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Peat, Marwick, Mitchell & Co.

February 21, 1979

Stock/Dividend Data

Range of sales prices of the Company's common stock, on the New York Stock Exchange (Symbol: PNM), and dividends paid on both common and preferred stock for fiscal 1978 and 1977, by quarters. (Unaudited)

COMMON STOCK

	Range of Sales Prices		Dividends
	High	Low	Per Share
Fourth Quarter, 1978	20½	18⅜	$0.44
Third Quarter, 1978	21¾	19⅝	0.44
Second Quarter, 1978	21⅛	19¼	0.42
First Quarter, 1978	21⅝	19⅜	0.42
Fiscal Year	21¾	18⅜	$1.72
Fourth Quarter, 1977	22½	20	$0.42
Third Quarter, 1977	23½	21	0.40
Second Quarter, 1977	23¾	21⅛	0.40
First Quarter, 1977	24	21⅜	0.39
Fiscal Year	24	20	$1.61

PREFERRED STOCK

	1965 Series, 4.58%	*1974 Series, 9.2%*	*1975 Series, 10.12%*	*9.16% Series*	*8.48% Series*	*8.80% Series*
			(Dividends per share)			
Fourth Quarter, 1978	$1.145	$2.30	$ 2.53	$0.5725	$2.12	$2.20
Third Quarter, 1978	1.145	2.30	2.53	0.5725	2.12	2.078
Second Quarter, 1978	1.145	2.30	2.53	0.5725	2.12	
First Quarter, 1978	1.145	2.30	2.53	0.5725	2.12	
Fiscal Year	$4.58	$9.20	$10.12	$2.2900	$8.48	$4.278
Fourth Quarter, 1977	$1.145	$2.30	$ 2.53	$0.5725	$2.12	
Third Quarter, 1977	1.145	2.30	2.53	0.5725	2.12	
Second Quarter, 1977	1.145	2.30	2.53	0.5725	2.167	
First Quarter, 1977	1.145	2.30	2.53	0.5725		
Fiscal Year	$4.58	$9.20	$10.12	$2.2900	$6.407	

Note: While isolated sales of the Company's preferred stock have occurred in the past, the Company is not aware of any active trading market for its preferred stock.

Officers and Directors

Board of Directors

H. L. GALLES, JR.* — *Chairman of the Board, Galles Chevrolet Company — Albuquerque, New Mexico*
J. D. GEIST* — *President, Public Service Company of New Mexico*
C. E. LEYENDECKER† — *President, Mimbres Valley Bank — Deming, New Mexico*
R. F. MATHER† — *Assistant to the Mayor for Economic Development, AIDS/IFA*
D. W. REEVES* — *Chairman of the Executive Committee, Public Service Company of New Mexico*
R. R. REHDER — *Dean, Robert O. Anderson Graduate School of Management, University of New Mexico — Albuquerque, New Mexico*
G. A. SCHREIBER* — *Chairman of the Board, Public Service Company of New Mexico*
R. H. STEPHENS† — *President, Stephens-Irish Agency — Las Vegas, New Mexico*
E. R. WOOD — *President, Santa Fe Motor Company — Santa Fe, New Mexico*

* *Members of the Executive Committee*
† *Members of the Audit Committee*

Officers

G. A. SCHREIBER — *Chairman of the Board*
J. D. GEIST — *President*
R. B. ROUNTREE — *Senior Vice President*
R. MULLINS — *Vice President, Operations*
C. D. BEDFORD — *Vice President, Administration*
J. P. BUNDRANT — *Vice President, Division Operations*
J. B. MULCOCK — *Vice President, Public Affairs*
R. F. MERSHON — *Vice President, Industrial Relations*
D. E. PECKHAM — *Secretary and Treasurer*
B. D. LACKEY — *Controller*
P. J. ARCHIBECK — *Assistant Secretary and Assistant Treasurer*
A. J. ROBISON — *Vice President, Finance*
B. P. LOPEZ — *Assistant Secretary*
H. L. HITCHINS, JR. — *Assistant Secretary and Assistant Treasurer*
W. A. BADSGARD — *Western Division Manager*
F. E. GRAY — *Vice President, Urban Development*
E. L. FOGLEMAN — *Las Vegas Divison Manager*
P. R. GAMERTSFELDER — *District Vice President, Santa Fe and Las Vegas*
J. L. SMITH — *Belen Division Manager*
W. R. STONE — *Deming Division Manager*
T. P. WARNKE — *San Juan Area Manager*
L. C. EDWARDS — *Bernalillo Division Manager*
W. M. HICKS, JR. — *Manager, Water Operations, Santa Fe*
J. T. ACKERMAN — *District Vice President, Albuquerque and Western Area*
R. A. LAKE — *District Vice President, Belen, Bernalillo and Deming Divisions*

Executive Offices

414 Silver Avenue SW, Albuquerque, New Mexico

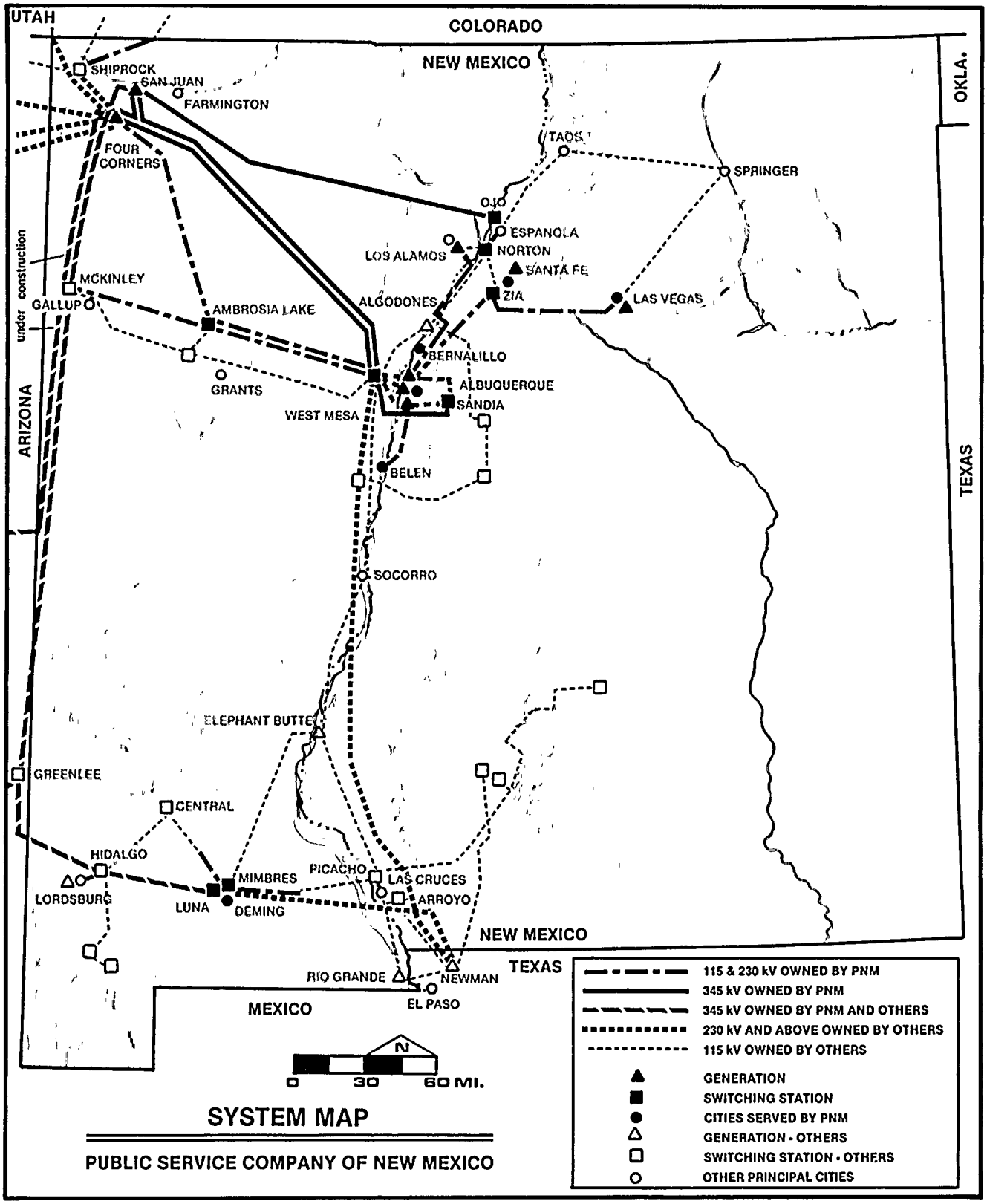
Transfer Agents

Albuquerque National Bank, Albuquerque, New Mexico
Chemical Bank, New York, New York
Irving Trust Company, New York, New York

Registrars

First National Bank in Albuquerque, Albuquerque, New Mexico
Chemical Bank, New York, New York
Irving Trust Company, New York, New York

System Map



SYSTEM MAP

PUBLIC SERVICE COMPANY OF NEW MEXICO

PNM

PUBLIC SERVICE COMPANY OF NEW MEXICO
POST OFFICE BOX 1047
ALBUQUERQUE, NEW MEXICO 87103

RETURN REQUESTED

ALBUQUERQUE NEW MEXICO

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PAID
Albuquerque, N.M.
Permit No. 13

SECTION 4

GENERAL INFORMATION RESPECTING JOINT APPLICANT SALT RIVER PROJECT AGRICULTURAL IMPROVEMENT AND POWER DISTRICT

(a) Name of joint applicant:

Salt River Project Agricultural Improvement and Power District (Salt River Project)

(b) Address of joint applicant:

Post Office Box 1980
Phoenix, Arizona 85001

(c) Description of business of joint applicant:

Salt River Project is an agricultural improvement district which operates a federal reclamation project under contracts with the United States of America and provides electric service to residential, commercial, industrial, and agricultural power users in parts of Maricopa, Gila, and Pinal counties.

(d) (1) Not applicable.

(d) (2) Not applicable.

(d) (3) (i) State of incorporation and principal location:

Salt River Project is a political subdivision of the State of Arizona, organized and existing under and pursuant to the provisions of Title 45, Chapter 4, Arizona Revised Statutes. Salt River Project's principal place of business is in Maricopa County, State of Arizona, and its activities are carried out within the State of Arizona.

(d) (3) (ii) Names, addresses, and citizenship of directors and principal officers of the Salt River Project:

Directors of Salt River Project

Name	Address
Germain H. Ball	2108 East Pasadena Phoenix, Arizona 85016
Alex M. Conovaloff	Post Office Box 36 Tolleson, Arizona 85353
Bill Rousseau	Route 4, Box 822 Phoenix, Arizona 85031
Gilbert R. Rogers	Route 1, Box 307 Laveen, Arizona 85339
John M. Williams, Jr.	Route 1, Box 532 Laveen, Arizona 85339
Thomas P. Hurley	505 East Glenn Drive Phoenix, Arizona 85020
William P. Schrader	5611 Calle Camelia Phoenix, Arizona 85018
Thomas M. Owens, Jr.	130 West Palmcroft Drive Tempe, Arizona 85281
Larkin Fitch	945 North Center Mesa, Arizona 85201
Tom Finley	Route 2, Box 126C Gilbert, Arizona 85234
William W. Arnett	1459 North Gaylord Circle Mesa, Arizona 85203
John L. Burton, Jr.	3427 North 47th Street Phoenix, Arizona 85018

Principal Officers of Salt River Project

Name	Address
Karl F. Abel	President 4627 West Seldon Lane Glendale, Arizona 85302
John R. Lassen	Vice President 1320 Whalers Way Tempe, Arizona 85283

Each of the directors and principal officers of Salt River Project Argicultural Improvement and Power District is a citizen of the United States of America.

(d) (3) (iii) Salt River Project is not owned, controlled, or dominated by an alien, a foreign corporation, or a foreign government.

(d) (4) Salt River Project is not acting as agent or representative of another person in filing the joint application.

(e) See Section 1 (e) hereof.

(f) In accordance with 10CFR50, Appendix C, a copy of joint applicant Salt River Project's 1978 Financial Report is attached herto as Appendix 4A.

(g) (Not used)

(h) Not applicable.

(i) There are no regulatory agencies which have jurisdiction over the rates or services provided by the Salt River Project and associated with this facility.

News publications which circulate in the area are:

The Arizona Republic
120 East Van Buren
Phoenix, Arizona 85004

The Phoenix Gazette
120 East Van Buren
Phoenix, Arizona 85004

Buckeye Valley News
P.O. Box 217
Buckeye, Arizona 85326

(j) Not applicable.

APPENDIX 4A

SALT RIVER PROJECT 1978 ANNUAL REPORT

Salt River Project 1978 Annual Report

Contents

Photos

Front cover: Falls on the Salt River in Salt River Canyon

Page one: Sunset at the Coronado Generating Station switchyard

Back cover: Navajo Generating Station at dawn

Background

Since 1903 Salt River Project has played a leading role in the growth of the Valley of the Sun by providing utility services of water and power to area residents.

The Project consists of two organizations—the Salt River Project Agricultural Improvement and Power District (the District), and the Salt River Valley Water Users' Association (the Association).

The District, a political subdivision of Arizona, operates under contracts with the United States of America, and provides electricity to residential, commercial, industrial and agricultural power users in a 2,900-square-mile service territory in parts of Maricopa, Gila and Pinal counties.

The Association is a private Arizona corporation. It participates in the management of the 13,000-square-mile watersheds of the Salt and Verde rivers, in cooperation with the U.S. Forest Service. The Association administers water rights of the Project's 250,000-acre area and operates and maintains the irrigation transmission system which carries SRP water to municipal, agricultural, industrial and residential users.

Following the long-standing reclamation principle, SRP uses electric revenues to help support its water and irrigation operations. This helps keep water delivery charges at reasonable levels. Simultaneously, SRP maintains competitive rates for the electric service it provides.

1978 Highlights

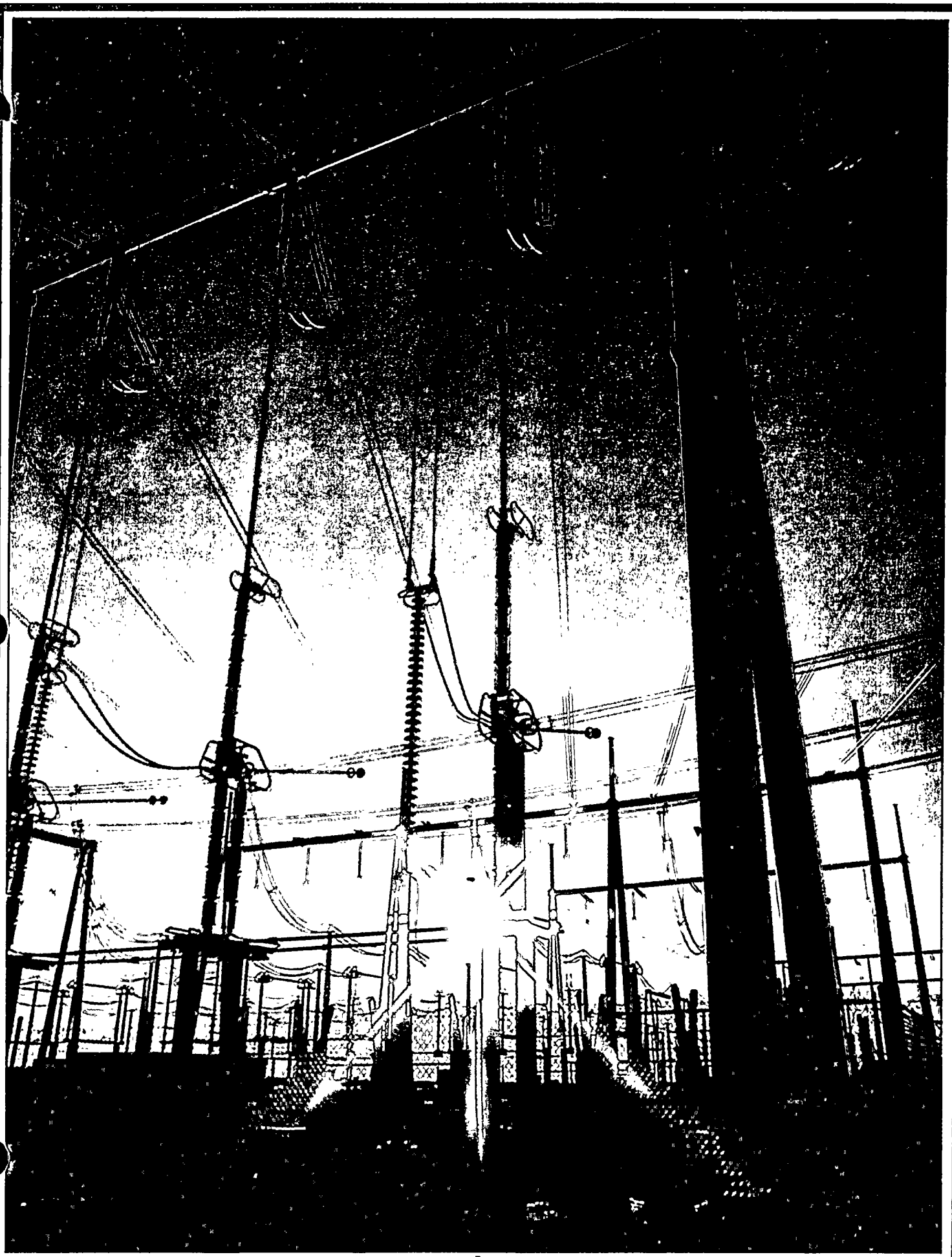
Sources	Dollars	Percent
Residential	$154,783,160	45.8%
Commercial and Industrial	127,576,875	37.8
Sales for resale	33,160,281	9.8
Agricultural pumping, street and highway lighting, and public authorities	15,275,913	4.5
Water and irrigation revenues	4,435,320	1.3
Other	2,532,734	.8
Total	$337,764,283	100.0%

Uses		
Fuel used for generation	$ 73,049,643	21.6%
Purchased power	23,449,320	6.9
Other operating expenses	52,051,380	15.4
Taxes and tax equivalents	38,339,321	11.4
Depreciation and amortization	30,806,303	9.1
Maintenance	29,201,129	8.7
Net interest on indebtedness	24,744,780	7.3
Miscellaneous deductions	329,611	.1
Reinvested	65,792,796	19.5
Total	$337,764,283	100.0%

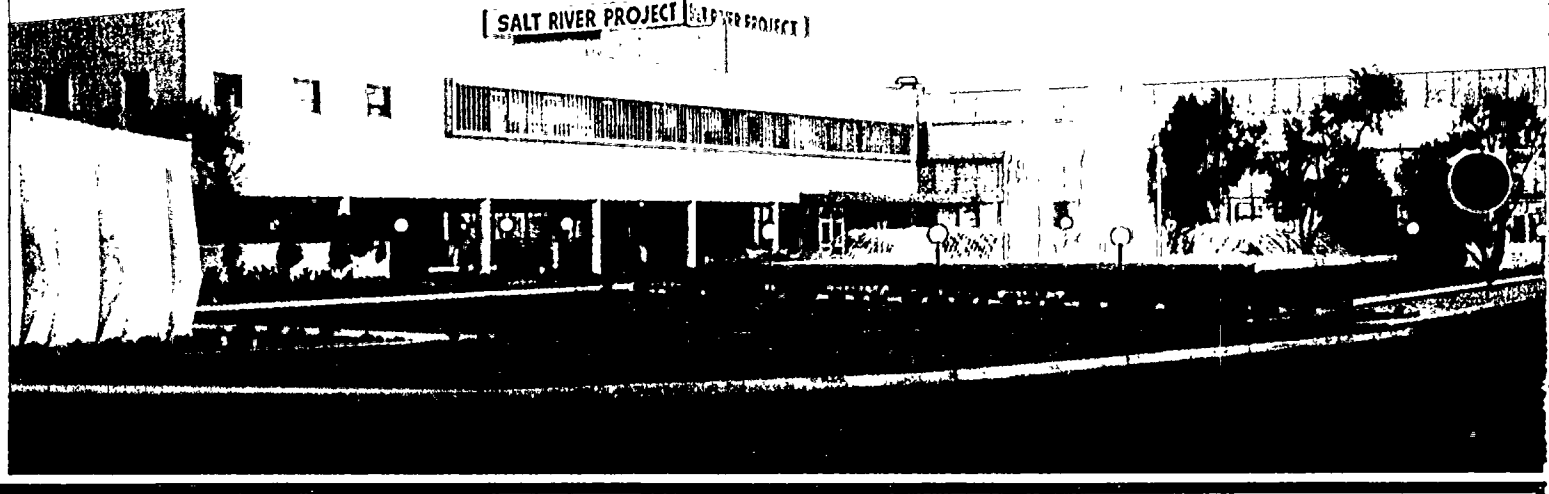
Operations	1978	1977
Assessed water accounts	171,875	168,736
Water runoff (acre-feet)*	3,389,051	367,122
Water in storage, Dec. 31 (acre-feet)	1,548,742	288,660
Sources of water for deliveries (acre-feet)	1,050,647	1,209,197
Number of power customers	288,902	268,891
Average annual use per residential customer (kwh)	12,799	13,108
Average annual kwh cost per residential customer (cents)	4.72	4.25
Energy generated, purchased, interchanged and wheeled (kwh)	10,206,012,000	10,294,543,000
Peak load for Project customers (kw)	1,854,000	1,731,000

Financial data	1978	1977
Electric revenues	$ 333,328,963	$ 305,620,727
Water and irrigation revenues	4,435,320	5,466,506
Total operating revenues	$ 337,764,283	$ 311,087,233
Taxes and tax equivalents	$ 38,339,321	$ 34,256,598
Total operating expenses	$ 246,897,096	$ 220,384,141
Net revenues	$ 65,792,796	$ 53,208,570
Plant investment, year-end gross	$1,912,139,350	$1,473,519,826
Long-term debt	$1,656,014,275	$1,428,270,291

**Based on U.S.G.S. provisional records and subject to adjustment.*



Project personnel work as a team to supply adequate water and power to customers. Leading that team in 1978 were President Karl Abel (right), General Manager Jack Pfister (center), and Vice President John Lassen.



Letter from management

The year 1978 can be summed up in a single word: wet.

As Salt River Project neared the end of its 75th year of operation, it also experienced the second wettest runoff year since records have been kept. And that was in sharp contrast with 1977, which was the second driest runoff year on record.

Water flowed in the Salt River channel, through the Valley of the Sun, twice during the year—in March and again in December. And, the flow continued into 1979. The unusual water situation challenged the talents of Project personnel, many of whom worked around-the-clock to cope with the emergency conditions and to help minimize the impact on the area.

On the power side of SRP's operations, Project customers established a new peak usage of 1,854,000 kilowatts (kw) on July 20. That was 123,000 kw higher than the previous year. Part of the increase can be attributed to the Project's rapid customer growth—we added more than 20,000 new power customers during the year. In addition, the Valley experienced a very hot and humid summer, which increased the amount of electricity used to operate air conditioners.

Various construction projects continued throughout 1978, with work progressing steadily at Coronado, Craig and Palo Verde generating stations.

To operate new facilities and meet needs of additional customers, the number of SRP employees rose from 3,652 at the end of 1977 to 4,226 at the end of 1978.

The Project's financial condition remained bright. Net revenues for the year were $65.8 million. These financial results and a thriving local economy made it possible for SRP to complete the year without an electric rate increase. However, late in the year, the board authorized a rate increase for 1979—the first in almost two years.

SRP's bonds maintained their "Aa" rating by Moody's Investor Service and their "A+" rating by Standard and Poor's Corporation, reflecting the financial community's confidence in Project operations and the local economy. During 1978 SRP issued $317.9 million in Electric System Revenue Bonds. About $83 million of that was used to refund the 1975 Series A Bonds, resulting in a gross savings in debt service of more than $9 million. The remainder was used to finance construction and improvements of electrical facilities.

In the fall, SRP hosted its sixth bond information program for banking, investment and bond officials from around the nation. The programs, which began in 1953, are designed to provide pertinent information to the representatives of firms that purchase and sell SRP bonds.

The biennial election of board and council members was held in April, marking the first time that two at-large members were elected to serve on the District's board. Two more at-large members will be added in 1980.

In January, SRP experienced a labor strike which lasted 23 days. A two-year contract with a wage re-opener was ratified by the International Brotherhood of Electrical Workers Local 266 on Feb. 2.

The past year set the stage for tasks and challenges which lie ahead. SRP must continue to meet its important day-to-day responsibilities of providing dependable supplies of water and power to its customers. Other duties include putting Coronado Generating Station into commercial operation, and helping to complete Craig Generating Station.

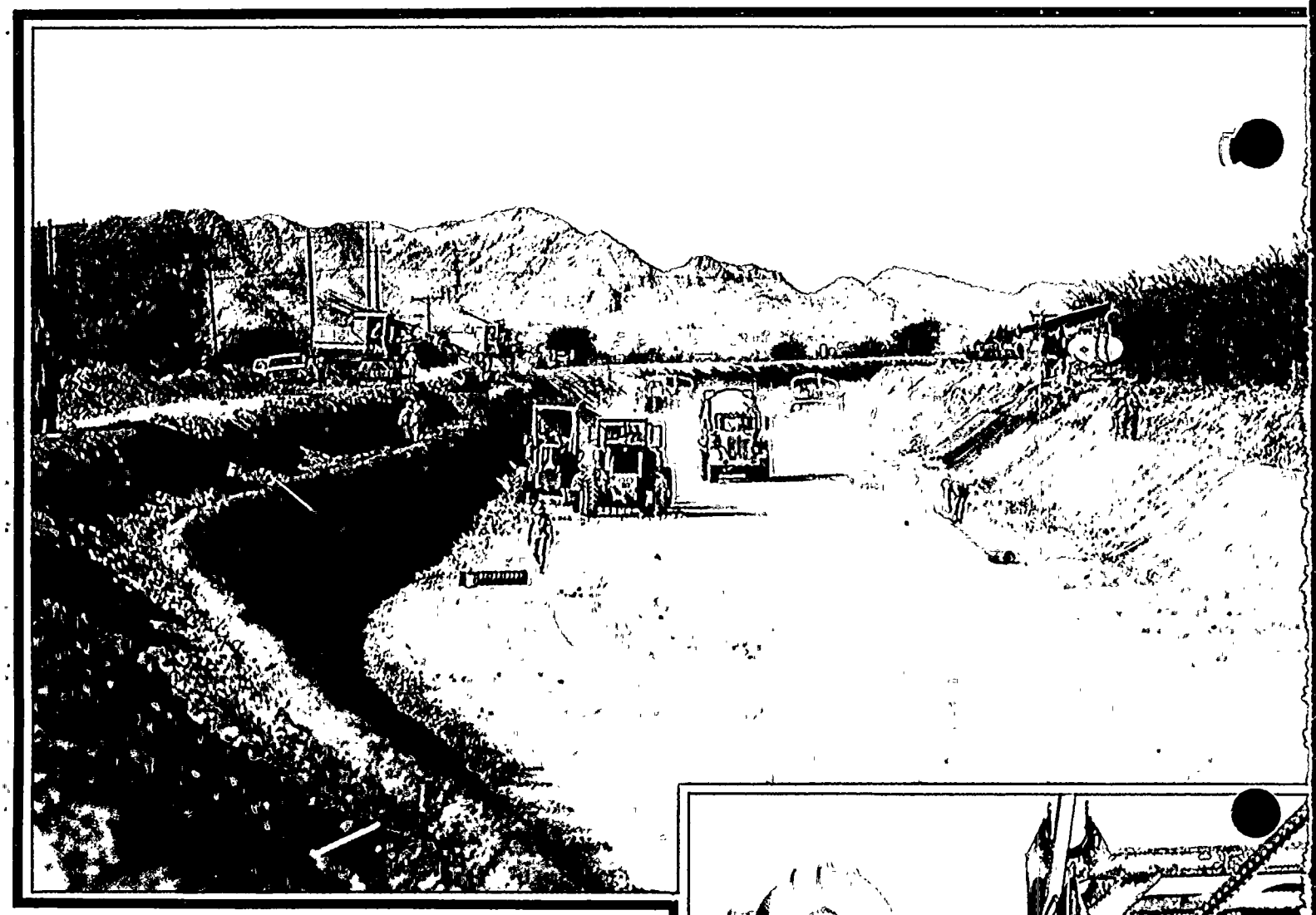
In July 1978, a Joint Labor-Management Committee was formed to develop a cooperative effort for improving labor relations. In January 1979, union members approved extending the existing contract through 1980. The extension provides wage increases for hourly employees averaging 7.5 percent annually, a five-cent-per-hour raise in shift differentials and potential cost-of-living adjustments. The settlement is within the wage-price guidelines established by President Carter.

Studies about the location of a possible new pumped-storage hydroelectric generating unit continued last year, and a decision about a prime site was made in early 1979. Construction could begin in 1985.

Possible changes in the state groundwater code are being studied and SRP has instituted negotiations with upstream Indian tribes about water rights. Because of its broad experience in water management, SRP continues to be active in matters relating to water within the state.

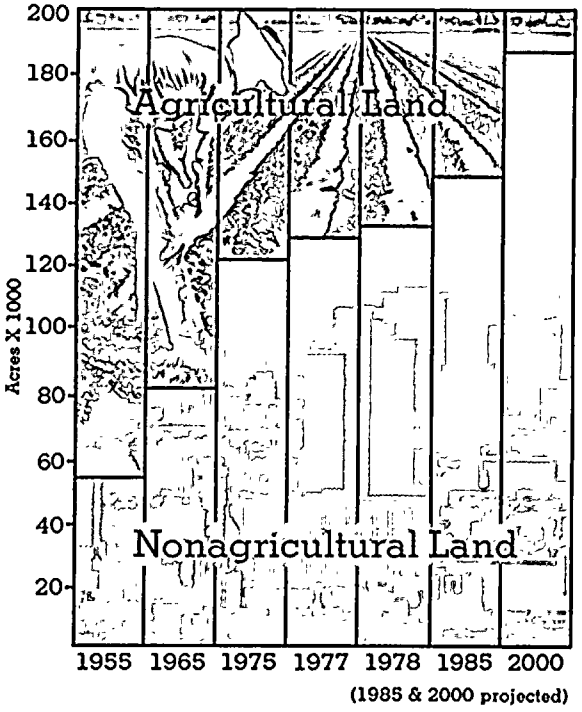
To finance construction in 1979, nearly $380 million will be raised through bond sales.

Despite the difficulties which 1978 presented, SRP's management and employees demonstrated outstanding performance in meeting the year's crises. And that proved, once again, that people are the Project's most valuable asset.



Once a year, canals north and south of the Salt River are emptied for maintenance. This annual work allows the Project to improve the efficiency of the water delivery system and helps ensure an adequate supply to meet Valley water needs. SRP power personnel are a familiar sight around the Valley, making sure that facilities are kept in top shape to supply customers' demands.

Land Use



(1985 & 2000 projected)

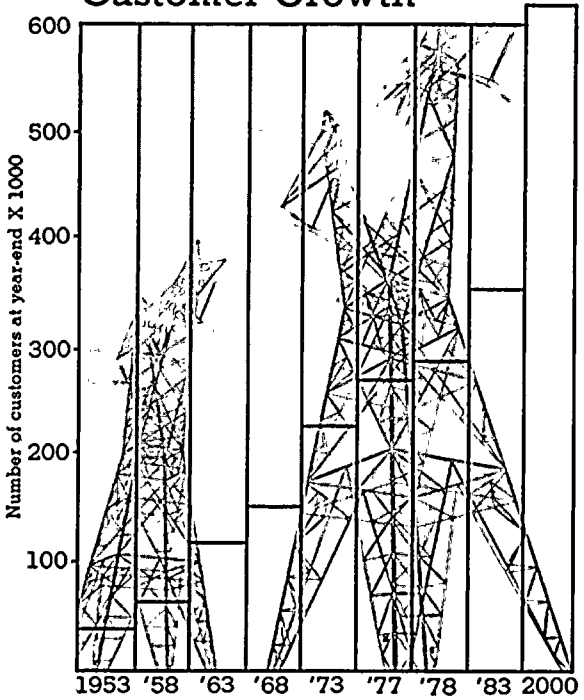
Domestic Water Use

	1978	1977	% Of Change*
Scottsdale	2,391.72	2,273.45	5.2
Glendale	12,629.47	11,342.65	11.3
Peoria	1,095.92	1,102.48	(0.6)
Gilbert	1,709.27	1,462.61	16.9
Tempe	21,640.25	22,588.46	(4.2)
Mesa	16,106.77	16,471.44	(2.2)
Chandler	1,962.53	1,249.35	57.1
Phoenix	140,692.33	149,430.92	(5.8)
Total	198,228.26	205,921.36	(3.7)

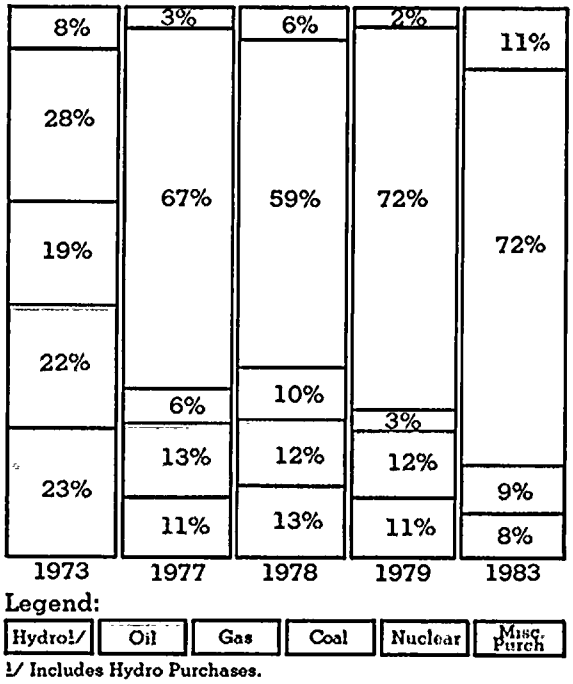
(all numbers except percent of change are in acre-feet)

** Parentheses indicate a reduction in water use.*

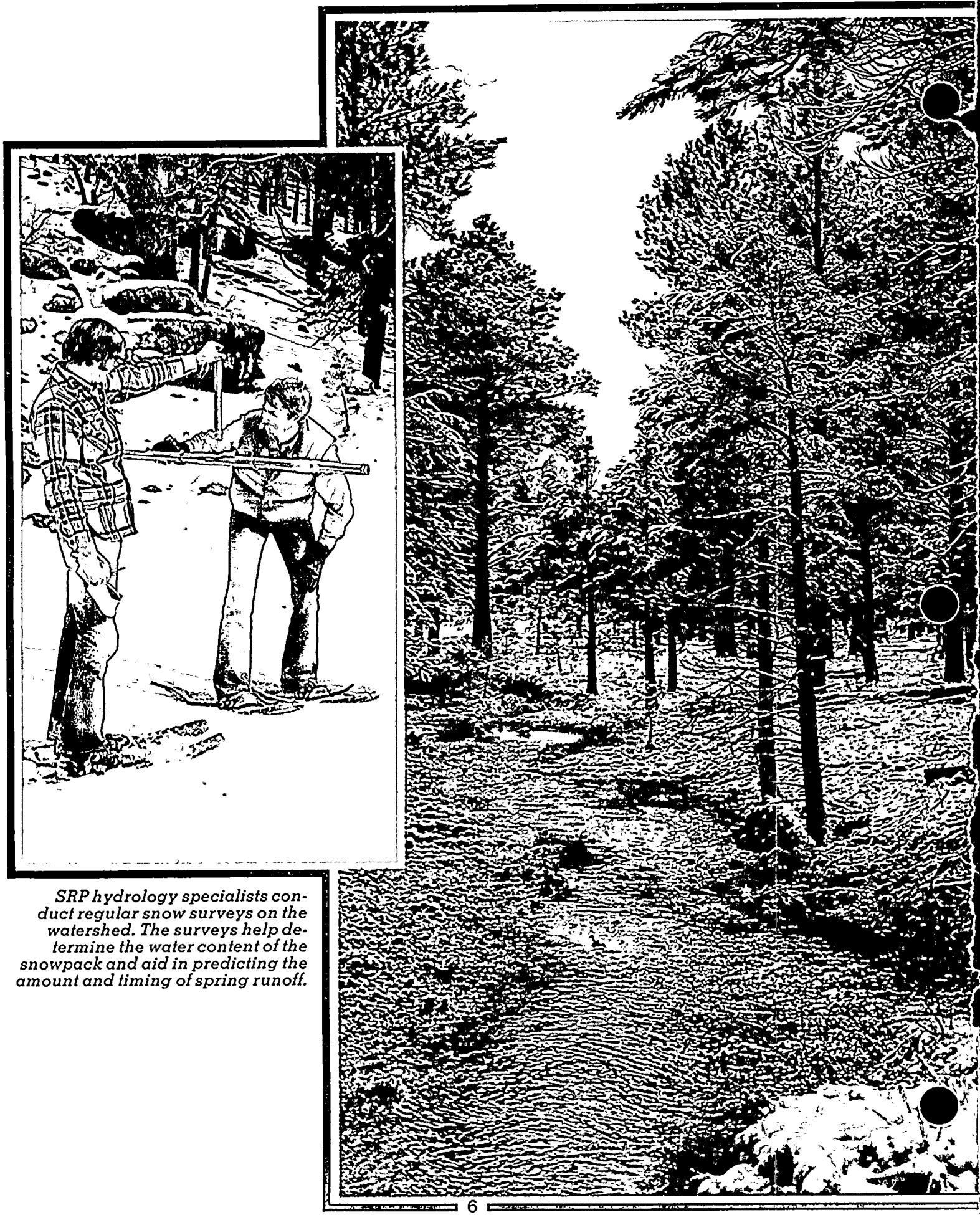
Customer Growth



Project Fuel Sources



1/ Includes Hydro Purchases.



SRP hydrology specialists conduct regular snow surveys on the watershed. The surveys help determine the water content of the snowpack and aid in predicting the amount and timing of spring runoff.

Water . . . lifeblood of a blooming desert

Last year was an unprecedented one for Salt River Project's water operations.

When 1978 began, Valley residents were still concerned about the effects of a drought which had lasted more than two years. In fact, in January, the water supply for SRP looked bleak. The Project's six lakes held less than one-quarter of their storage capacity. The board had cut the normal water allotment by one-third.

Then it started raining. The rains in late February and the first few days of March produced near-record runoff from the watershed, and turned the normally placid Salt and Verde rivers into raging torrents.

When the storms began on February 28, SRP's reservoirs were 39 percent full, with 817,012 acre-feet (af) in storage. On March 9, after the rains, the lakes were 79 percent full, with 1,626,565 af in storage.

On April 20, the lakes reached their peak springtime storage—1,998,977 af, or 97 percent full.

Above average rainfall continued throughout the year, making 1978 the second wettest on record. In mid-December another massive storm struck the watershed, dumping from two to four inches of rain on the already saturated soil and melting what snow existed. The Salt and Verde rivers once again reached flood stage.

On December 17, the lakes contained 1,673,949 af of water, or 81 percent of capacity. By December 22, the lakes were 92 percent full, with 1,900,134 af in storage.

SRP's primary purpose and responsibility is to store as much water as possible in its reservoirs for use during Arizona's more typical dry years. But when flooding conditions occur, the Project switches to a flood control mode of operation. This helps reduce the impact of the flooding on the Valley.

In March, for instance, inflows into SRP reservoirs peaked at more than 230,000 cubic feet per second (cfs). But releases from the lakes reached a peak of only 115,000 cfs.

Again, in December, rapid action by SRP employees limited releases from reservoirs to 115,000 cfs—less than half the peak inflows of about 266,000 cfs.

At the close of 1978 the Salt storage system was filled to 90 percent of its capacity, and the Verde storage system held 88 percent of its capacity. These statistics assure the Valley of an ample supply of water during the next few years.

Dry canals make way for maintenance

In the fall, the Project drained canals on the north and south sides of the Salt River so crews could perform annual maintenance work. During the northside dryup, SRP lined nearly three miles of the Arizona Canal. The Project also repaired the canal lining in the Arizona Canal, below Granite Reef Dam, that was damaged by storms in February and March. Other work performed by SRP included modifying four canal structures on the Arizona Canal and one on the Grand Canal.

SRP concentrated on the Eastern Canal during the southside dryup, lining one-half mile of the canal and modifying a turnout structure.

State, city and county agencies coordinated modification and construction of bridges across canals with the dryup.

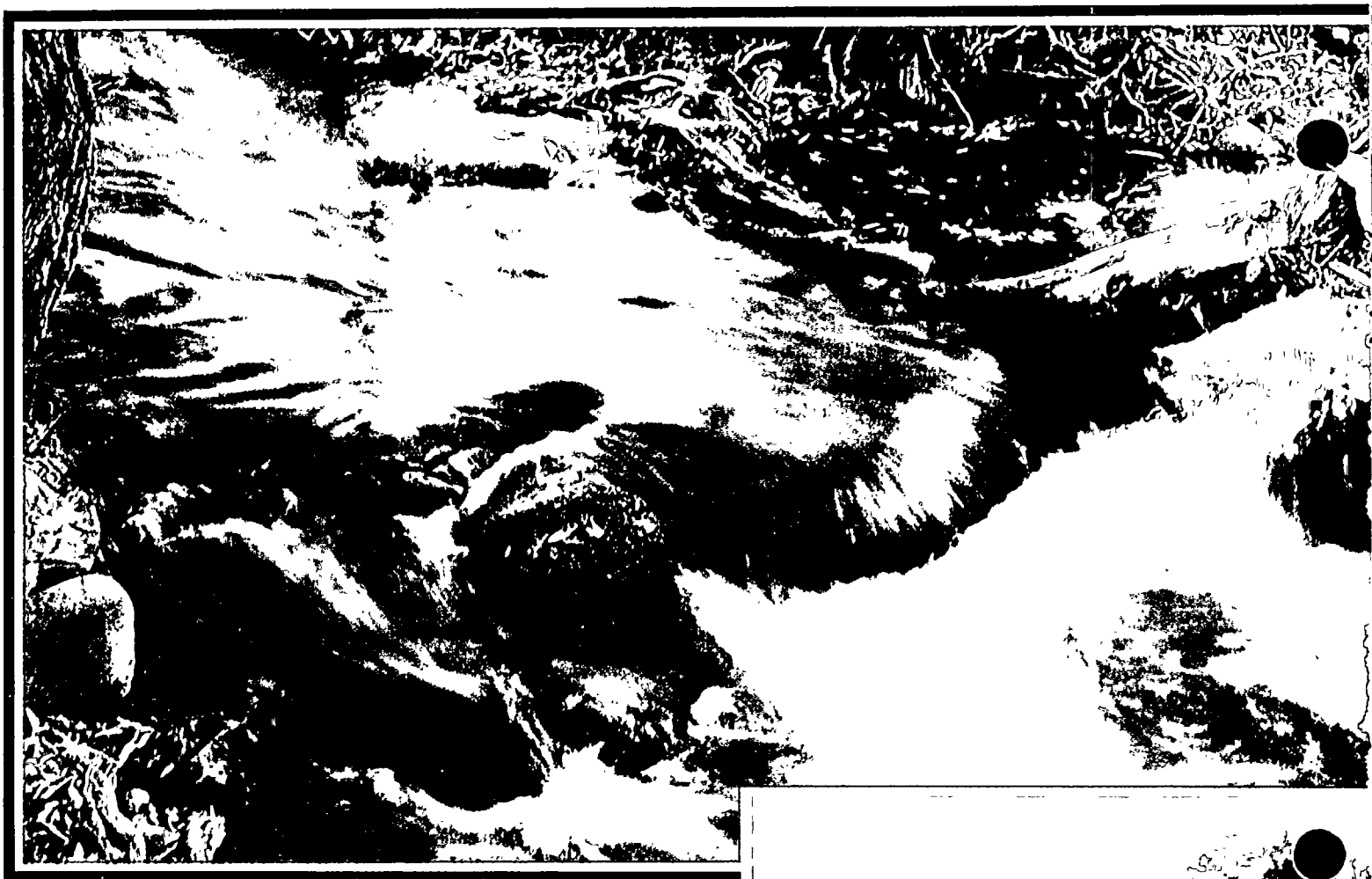
Total cost of SRP work performed during the dryups was about $600,000.

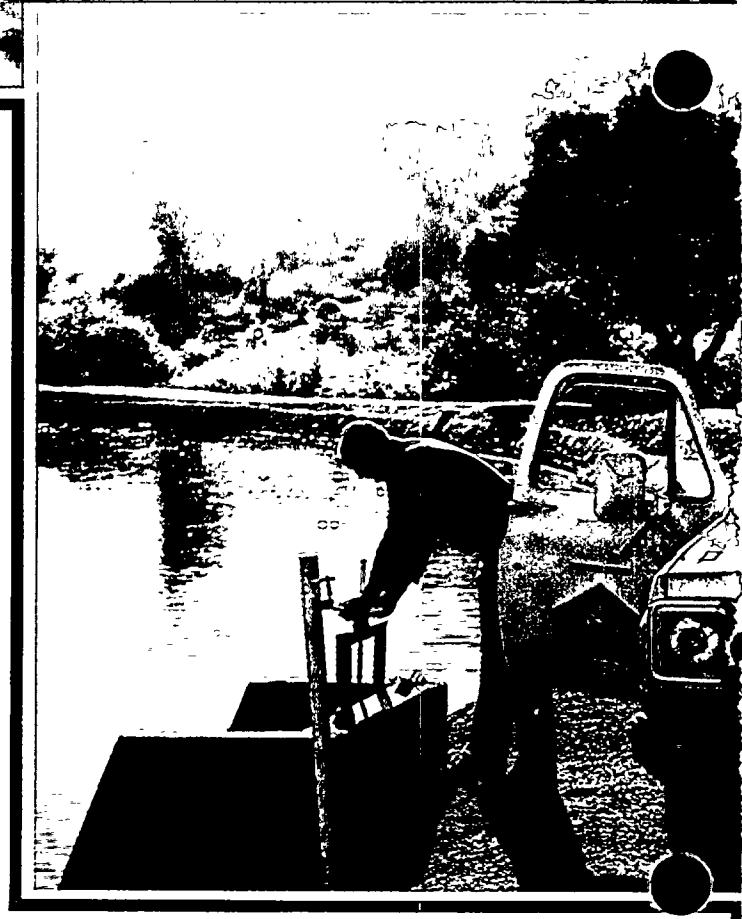
Horseshoe Lake drained for silt survey

In September, Horseshoe Lake, on the Verde River, was drained so the Project could conduct a silt survey and clear debris and trash from the dam's outlet structure. A similar study was performed at Bartlett Lake in 1977. The studies showed that capacity of the two lakes had dropped by 8,102 af since the last survey, in 1963. Horseshoe now can hold 131,427 af and Bartlett can store 178,186 af, for a total storage capacity on the Verde reservoir system of 309,613 af.

Storms damage SRP facilities

The year's unusual weather took its toll near five of the Project's six dams. The worst damage occurred below the Bartlett Dam spillway. Serious erosion in the channel immediately below the spillway resulted, first in March and again in December, due to heavy releases of water. Similar channel damage and damage to access roads occurred at Roosevelt, Horse Mesa, Stewart Mountain and Horseshoe dams. Repair costs, including those related to January 1979 releases, are estimated to be about $6.1 million.





Water from streams flowing through the 13,000-square-mile watershed reaches SRP lakes. When needed, it is released into Project canals. SRP employees, called zanjeros, help deliver the water through Valley canals to the land for use by people.

Where the water went during '78

Water deliveries during the year totaled 862,503 af, 5.3 percent less than in 1977. The deliveries were divided among four categories: nonagricultural uses; decreed lands; agricultural uses; and contract deliveries.

SRP water used for nonagricultural purposes, including municipal and industrial uses, parks, playgrounds and residential irrigation, decreased to 291,550 af in 1978, from 316,325 af in 1977.

Deliveries to cities decreased 3.7 percent. During 1978 these deliveries totaled 198,228 af compared with 205,921 af the year before. Other nonagricultural uses required 93,321 af, down from 110,404 af in 1977.

Water used by decreed lands, which include Indian reservations, totaled 43,052 af, compared with 66,158 af last year.

Agricultural water orders decreased in 1978 to 400,707 af, compared with 441,103 af the previous year.

Contract deliveries for 1978 totaled 127,195 af, compared with 86,920 af in 1977. These deliveries include city uses on non-member lands; this quantity is replaced by the cities from other sources such as city wells.

Because of the year's heavy runoff, nearly all of the total deliveries during 1978 came from lakes—93.3 percent, compared with 65.0 percent in 1977. Wells produced the remaining percentages in both years. In the past 30 years, an average of 65 percent of water delivered by SRP has come from the lakes.

The Valley's water table also increased slightly during the year, as flows in the river from 1978's storms produced some groundwater recharge and because of the reduction in pumping.

Land use continues urbanization trend

During 1978, a total of 4,568 acres was converted from agricultural to urban use. At year-end there were 114,478 acres in the Project area being used for agricultural purposes and 134,049 acres being used for other purposes.

Despite the urbanization of land within SRP boundaries, water deliveries have remained relatively constant for more than 30 years. Experience suggests that a fully urbanized Project area would require about the same amount of water that is used today.

Zeroing in on groundwater

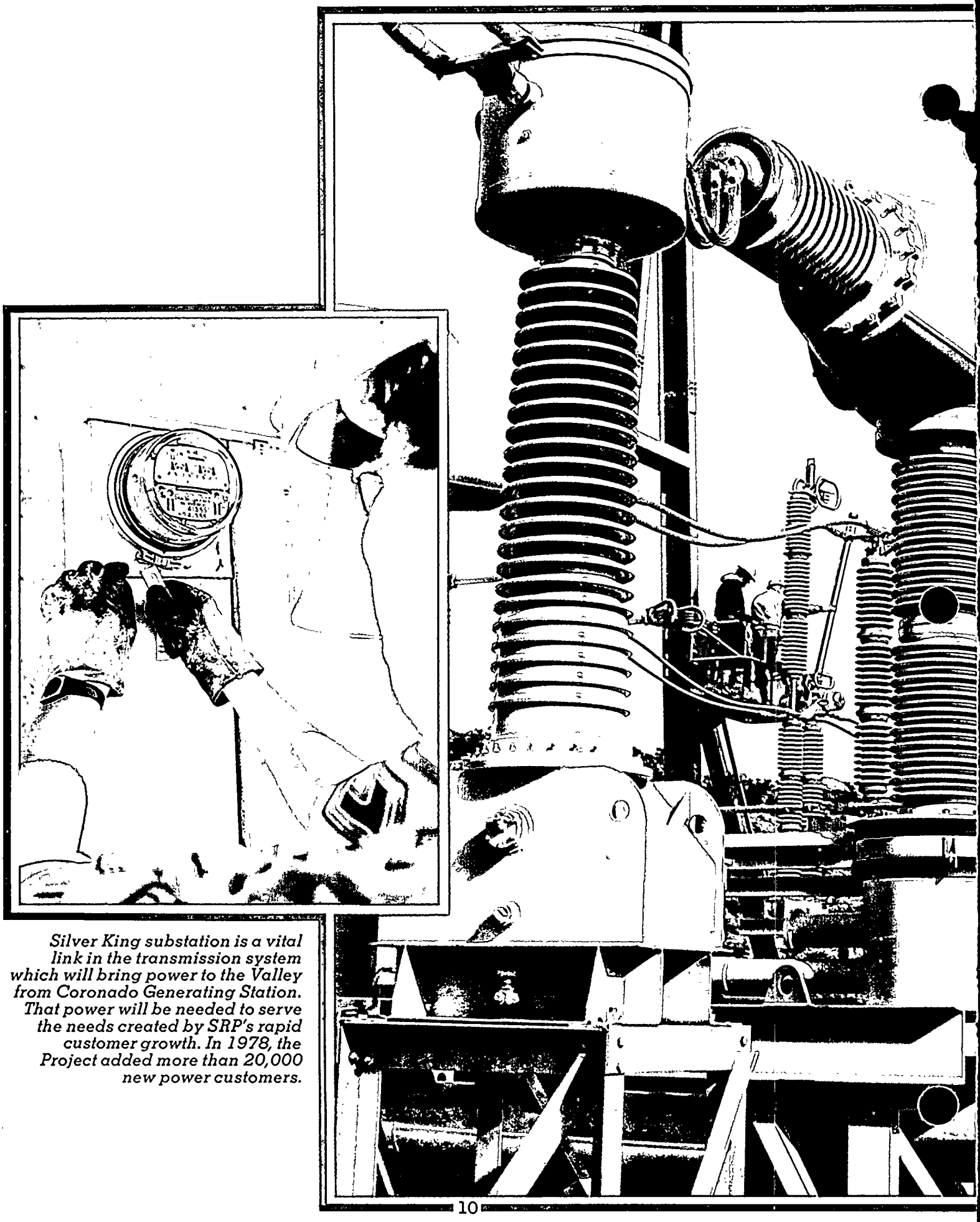
In late November, SRP sponsored a two-day symposium about the possibility of recharging the Salt River Valley's groundwater supply.

The consensus of the meeting was that prospects are slim for such recharging with flood flows. The biggest problems are a lack of surplus flood water to use for recharge, inability to recover much of the water used for recharge and high cost. The U.S. Army Corps of Engineers is developing a groundwater recharge plan as part of the Phoenix Urban Study; a report will be issued in early 1979.

Looking ahead

In late 1978 SRP's board raised water charges and delivery fees for the coming year by an average of 10 percent. The board set the 1979 water assessment at $11 per acre, 10 percent higher than the charge of $10 per acre in 1978.

The year was unusual for the Project. But 1978 was also a year which reinforced the vital role that SRP plays in the Valley of the Sun. Meticulous attention to the Project's task of water management allowed SRP to help protect the Valley from flood waters as well as store and supply water when and where needed.



Silver King substation is a vital link in the transmission system which will bring power to the Valley from Coronado Generating Station. That power will be needed to serve the needs created by SRP's rapid customer growth. In 1978, the Project added more than 20,000 new power customers.

Power . . . catalyst for a growing Valley

Providing people with efficient and dependable electric power is one of the other major responsibilities of SRP.

During 1978, the Project served 288,902 electric customers, an increase of more than 20,000 compared with 1977.

SRP uses a variety of fuels to generate power to meet its customers' demands. In 1978, the Project continued to rely heavily upon low-cost coal to generate electricity.

In the coming years, SRP's fuel mix will be dominated by coal, with nuclear power soon becoming part of the mix. When coal-fired units at Coronado and Craig are completed in 1979 and 1980, almost 75 percent of the Project's energy will come from coal. By 1983, after Palo Verde Nuclear Generating Station goes into operation, nuclear power will provide approximately 11 percent of SRP's electric generation, while coal will represent 72 percent. Using coal and nuclear instead of more expensive fuels, such as oil, will help keep consumers' electricity costs as low as possible.

Conservation—a high priority

SRP continued its efforts to encourage energy conservation by its customers last year. Power Saver Service, a program of free home energy inspections, began its second year. The purpose of the inspection is to identify conservation opportunities in homes. A similar inspection program, called the Commercial Energy Audit, is offered to commercial and industrial customers.

Power Saver Service offers to sell customers additional insulation and provides low-interest loans from SRP to finance the purchase. Water heater insulating jackets, weather-stripping kits for doors and sun screens also are available from the Project.

More than 8,000 inspections were performed during 1978, bringing the total number of customers taking advantage of the free service since its inception to nearly 19,000.

Actions taken in response to Power Saver Service recommendations can result in reduced peak demand. Such a reduction helps SRP curtail use of the more costly fuels, which helps lower the fuel cost adjustment factor applied to customers' bills. In the long run, decreased peak demand helps reduce the need for additional generating units. That can cause construction costs to be lower than originally estimated, and help hold down the size of future rate increases.

Budget payments aid customers

By the end of 1978, more than 22,650 customers were signed up for SRP's Budget Payment Plan. Under the plan—now in its second year—customers pay the same amount every month, winter or summer. Their payments are computed by averaging each customer's electricity charges for the last 12 months.

Extreme temperatures cause new peaks

In 1978, SRP customers established peak demands for both summer and winter. Very high temperatures resulted in a summer peak of 1,854,000 kilowatts (kw) on July 20. The previous record, of 1,732,000, was set in 1976.

Very low temperatures helped cause the winter peak of 1,469,000 kw on December 8. The previous high was 1,213,000 kw, set in January 1977.

Total energy sales decreased by more than 443 million kilowatt-hours (kwh) in 1978. The decline was due primarily to a reduction in irrigation pumping and in sales for resale.

Construction progresses at a steady pace

SRP was involved in construction of three generating stations in 1978. These were the Coronado station, near St. Johns, the Palo Verde nuclear station, near Buckeye, and the Craig station, near Craig, Colorado.

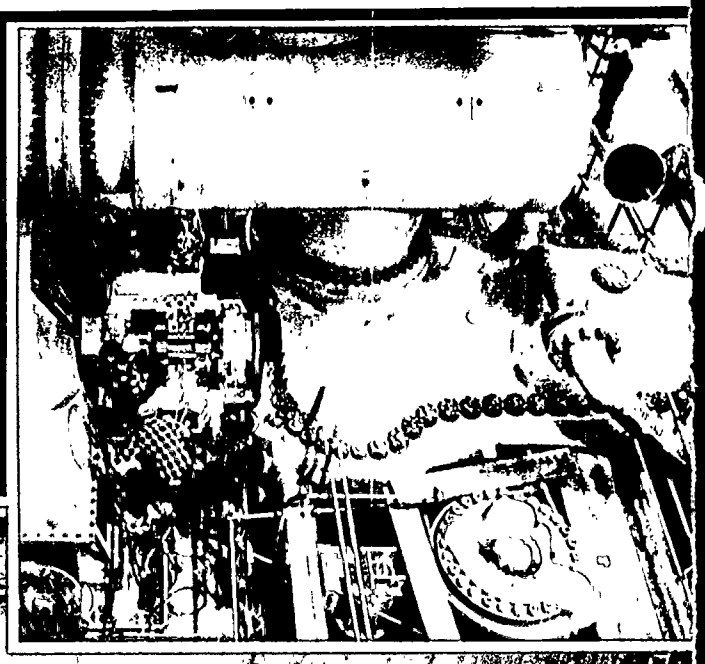
At year-end, Coronado's Units One and Two were approximately 75 percent complete. The Project presently owns 70 percent of the station's first two generating units; Los Angeles Department of Water and Power (LADWP) owns the remaining 30 percent. The units each have a capacity of 350,000 kw. They are scheduled for operation in 1979 and 1980. A third 350,000-kw unit is under construction at Coronado; it is expected to be completed by 1989.

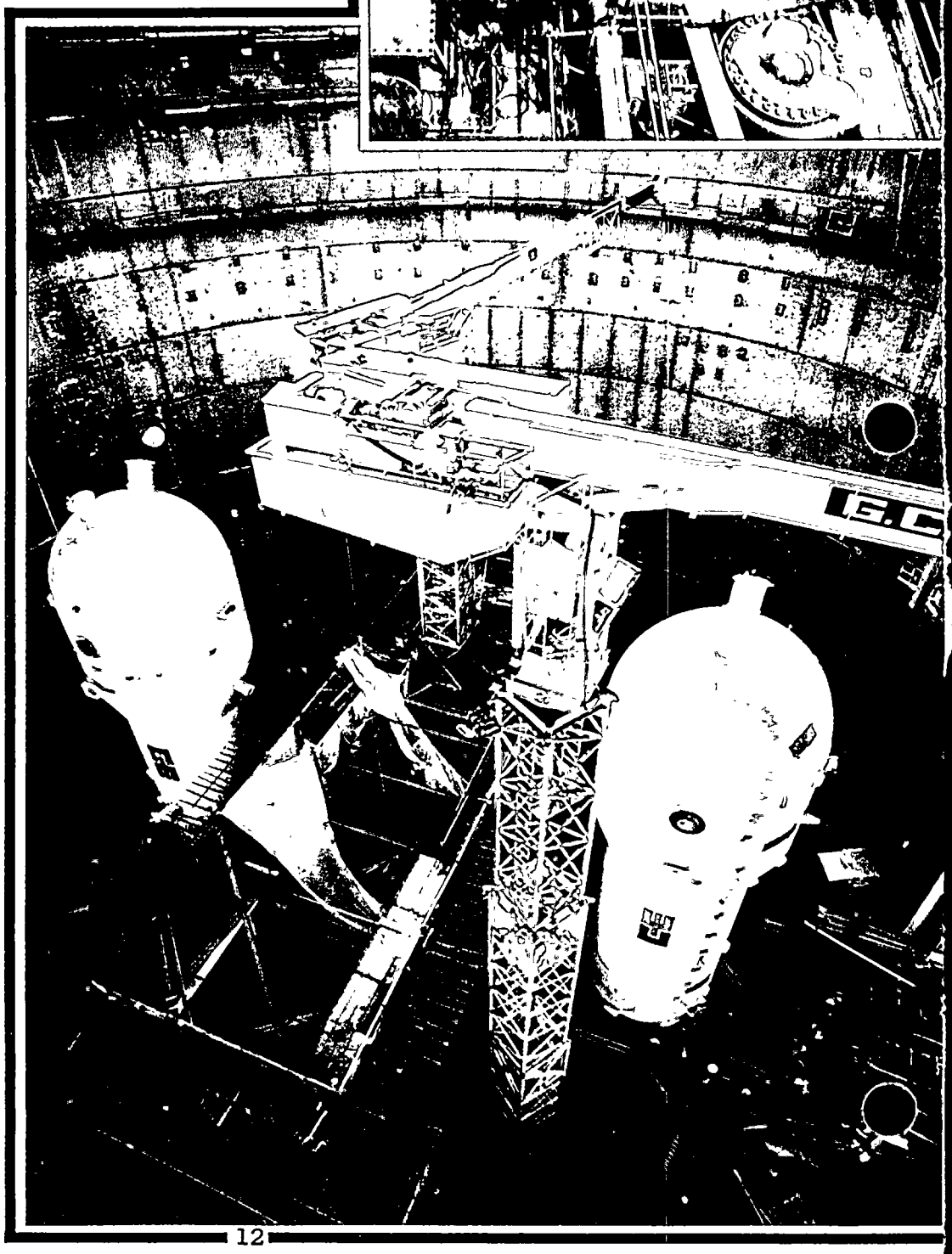
Major construction activities at Coronado during 1978 included installing piping for the station's various systems, electrical wiring and connections, insulation and preparation for start-up procedures.

Besides the station itself, there were a number of Coronado-related construction projects under way during the year. A 500-kilovolt (kv) transmission system to carry power from Coronado to delivery points in metropolitan Phoenix was 92 percent complete by year-end.

A back-up transmission system which

Two massive construction projects under way in 1978 were Coronado Generating Station, near St. Johns, and Palo Verde Nuclear Generating Station, near Buckeye. At right, a crew works on one of Coronado's turbine decks. Below, a bird's-eye view of two of the reactor vessels at Palo Verde.





connects with Arizona Public Service Company's Cholla Generating Station at Joseph City was completed in April. It will provide start-up power for Coronado.

Construction of a railroad spur between the town of Navajo and Coronado essentially was finished in 1978. This 43-mile-long spur connects with the main line of the Atchison, Topeka and Santa Fe Railroad and will be used to transport coal to the station.

Project crews also completed Phase I of the water system for Coronado at a site known as Concho Wellfield. The first phase will supply water for the station's first unit from five 600-foot-deep, 1,000-gallon-per-minute wells through a 21-mile-long pipeline. Completion of the water system means that no water will be needed from the town of St. Johns for the station's operation.

A second phase—the Patterson Wellfield—is under construction now, and will provide water for the second generating unit. A third phase, at Greer Wellfield, is under construction.

The estimated cost of Coronado's first two units is $647.2 million, excluding interest charges during construction.

Palo Verde blooms in the desert

During the year, work continued on the Palo Verde Nuclear Generating Station, near Buckeye. Initially, Palo Verde will consist of three 1,270,000-kw pressurized-water units. The first unit is scheduled to begin commercial operation in 1982. Total cost of the station's first three units, excluding interest charges during construction, is estimated at nearly $3 billion.

Major construction activities in 1978 included rough-setting the reactor vessel and two steam generators for Unit One, ground-assembly of the dome liner, concrete work for containment building number one, concrete work for Unit Two and excavation for Unit Three.

At year-end, Palo Verde's first three units were approximately 22 percent complete.

Craig—another source of power

SRP also owns 29 percent of the coal-fired Craig Generating Station, being built near Craig, Colorado. That station will consist of two 400,000-kw units that are expected to go into operation in 1979 and 1980.

At year-end, Craig was approximately 82 percent complete. The total cost of the station is estimated at $629.4 million, excluding interest charges during construction.

Pumped-storage site search narrows

During 1978, SRP evaluated a number of sites in Arizona for a possible pumped-storage facility which may be needed to meet future demands of SRP customers.

The Project presently has two pumped-storage units on the Salt River. These units allow SRP to pump water during off-peak demand periods from lower reservoirs to upstream lakes. This makes more water available for hydroelectric generation during times when demand for electricity is greatest. With more hydroelectric power available for use, SRP will depend less upon oil-fired generators, which have high fuel costs. The cost-savings can be dramatic—the Project reduced generating costs about $525,000 in June, July and August of 1978 by using the pumped-storage units.

By the end of 1978, possible sites for the new unit had been narrowed to six. A prime site was selected in early 1979.

SRP looks to the future with solar energy research

The Project joined Rockwell International Energy Systems Group in two projects aimed at developing a solar-powered generating facility. Both projects were funded by the United States Department of Energy at a combined cost of about $1.2 million.

In one project, SRP served as a utility consultant to Rockwell for a study to develop an advanced conceptual design for a solar central receiver.

The second project involves the conceptual design of a solar-hybrid unit to combine the use of fossil fuel and solar power in an advanced solar-electric generating system. In this study, SRP will review designs and supply inputs based upon actual practical experiences by an operating utility. SRP also will consult on matters involving costs, market analysis and operational requirements.

The long-term goal of both research efforts is to develop a solar-energy generating station that is comparable in cost to other power-generating facilities. Participants hope to develop a feasible design for the station by 1990.

Statistical review

PROJECT GENERAL	1978	1977	1973	1968
Operating revenues	$ 337,764,283	$ 311,087,233	$129,913,743	$ 55,255,488
Electric	333,328,963	305,620,727	128,334,924	54,001,010
Water and irrigation	4,435,320	5,466,506	1,578,819	1,254,478
Operating expenses	246,897,096	220,384,141	105,486,982	47,608,657
Net financing costs				
Less capitalized interest	24,744,780	37,451,163	7,258,248	2,444,249
Other deductions (revenues), net	329,611	43,359	(290,903)	545,047
Net revenues	65,792,796	53,208,570	17,459,416	4,657,535
Construction expenditures	406,124,480	229,922,827	164,176,873	28,484,254
Electric and irrigation plant, gross	1,912,139,350	1,473,519,826	688,078,340	278,398,505
Contributions of power revenues to support water operations	7,507,000	9,462,000	7,187,000	6,900,000
Taxes and tax equivalents	$ 38,339,321	$ 34,256,598	$ 12,691,099	$ 4,197,869
Employees at year-end	4,226	3,652	3,021	2,179

WATER	1978	1977	1973	1968
Total storage and pumping capacity (acre-feet)	2,811,600	2,810,645	2,840,943	2,861,870
Storage capacity (six reservoirs)	2,063,948	2,072,050	2,072,050	2,072,050
Installed pumping capacity	747,652	738,595	768,893	789,820
Water in storage January 1 (acre-feet)	511,093	976,725	1,434,947	1,485,305
Project storage only	288,660	711,353	1,051,824	1,176,456
Runoff (acre-feet)	3,389,051*	367,122*	2,514,341*	1,429,418*
Water in storage December 31 (acre-feet)	1,839,399	511,093	1,498,629	1,467,453
Project storage only	1,548,742	288,660	1,201,943	1,160,671
Sources of water for deliveries (acre-feet)	1,050,647	1,209,197	1,471,580	1,410,92
Gravity supply	977,988*	809,373*	1,392,150*	1,310,514
Groundwater supply (pumping by SRP)	66,747	391,627	76,537	97,445
Groundwater supply (pumping by others)	5,912	8,197	2,893	2,961
Use of water (acre-feet)	1,050,647	1,209,197	1,471,580	1,410,920
Agricultural	400,707	441,103	642,134	691,157
Urban	291,549	316,325	253,753	186,673
City domestic	198,228	205,921	152,626	97,211
Subdivision irrigation	49,615	57,952	51,761	49,746
Other nonagricultural irrigation (schools, parks, churches, etc.)	43,706	52,452	49,366	39,716
Decreed deliveries	43,052	66,158	72,727	61,114
Contract deliveries	127,195	86,920	198,669	142,326
Seepage and evapotranspiration	188,144	298,691	355,651	393,673
Canals, total (miles)	131	131	131	138
Lined	62	61	54	48
Laterals, total (miles)	880	878	876	872
Lined or piped	738	726	653	506
Drainage and waste ditches (miles)	251	250	267	285
Lined or piped	58	55	49	43
Assessed area (acres)	238,220	238,220	238,264	238,252
Number of assessed accounts	171,875	168,736	157,578	112,755
Number of times water delivered to users	429,276	493,043	512,964	494,421

**Based on U.S.G.S. provisional records and subject to adjustment.*

POWER

	1978	1977	1973	1968
Energy sources (kwh):				
Net steam generation*	7,221,663,000	7,499,002,000	4,360,347,000	1,516,724,000
Net diesel generation	0	0	0	0
Net combustion turbine generation	59,793,000	59,167,000	332,325,000	0
Net combined cycle generation	385,269,000	477,808,000	0	0
Net run-of-river generation	367,924,000	319,851,000	610,571,000	384,987,000
Pumped-storage generation	105,960,000	22,694,000	21,133,000	0
Total net generation*	8,140,609,000	8,378,522,000	5,324,376,000	1,901,711,000
Purchased	1,808,603,941	1,730,201,348	1,940,568,367	1,399,218,193
Interchange received	249,074,000	178,417,000	277,927,048	367,970,016
Wheeling received	7,725,059	7,402,652	40,667,485	36,474,538
Total energy sources*	10,206,012,000	10,294,543,000	7,583,538,900	3,705,373,747
Energy disposition (kwh)				
Residential	3,278,867,939	3,169,000,667	2,640,917,384	1,244,307,611
Commercial and Industrial	3,945,048,976	3,728,299,603	2,894,899,907	1,562,996,453
Irrigation pumping	206,269,684	283,926,606	218,566,804	209,164,775
Street and highway lighting	39,400,289	38,198,033	38,974,096	25,386,444
Public authorities	289,204,179	321,266,390	201,267,802	158,184,361
Interdepartmental	66,240,885	214,648,125	62,477,382	71,812,744
Sales for resale	1,340,060,575	1,859,308,829	855,118,667	154,281,613
Total sales	9,165,092,527	9,614,648,253	6,912,222,042	3,426,134,001
Interchange delivered	124,787,000	185,980,000	112,973,600	27,673,242
Wheeling delivered	7,307,903	6,854,855	37,536,087	33,447,152
Energy losses	759,125,570	453,313,892	489,467,171	218,119,352
Energy for pumped-storage operation	149,699,000	33,746,000	31,340,000	0
Total disposition of energy	10,206,012,000	10,294,543,000	7,583,538,900	3,705,373,747
Peak overall power system (kw)	2,196,000	2,149,000	1,759,000	824,000
Date and time (MST)	July 14, 3 p.m.	June 29, 5 p.m.	July 2, 6 p.m.	July 18, 5 p.m.
Peak Project customers (kw)	1,854,000	1,731,000	1,448,000	762,000
Date and time (MST)	July 20, 6 p.m.	Sept. 7, 6 p.m.	June 28, 6 p.m.	June 20, 6 p.m.
Generating capability (kw)**				
Steam*	1,548,250	1,548,250	850,400	532,200
Diesel	0	0	0	7,900
Combustion turbines	378,000	378,000	238,800	0
Combined cycle	288,000	288,000	0	0
Hydroelectric, conventional	94,000	94,000	94,400	54,100
Hydroelectric, pumped-storage	140,000	140,000	147,200	0
Total operating capability*	2,448,250	2,448,250	1,330,800	594,200
Contract purchase at time of peak	461,813	461,813	582,145	513,400
Total resources*	2,910,063	2,910,063	1,912,945	1,107,600
Electric customers year-end				
Residential	268,107	248,877	209,334	137,013
Commercial and industrial	19,274	18,526	15,443	11,372
Other	1,521	1,488	1,144	935
Total	288,902	268,891	225,921	149,320
Average annual kwh use - residential	12,799	13,108	13,182	9,401
Average annual kwh price - residential (cents)	4.72	4.25	2.23	1.94

* *Includes SRP participation in jointly owned projects.*

** *Figures reported indicate unit capabilities during summer peak. These capabilities will be utilized while units are under automatic generation control and may vary periodically due to system requirements and seasonal variations in temperature.*

Financial commentary

During 1978, SRP maintained its robust financial posture, with operating results meeting or exceeding expectations. Three bond issues, totaling $317.9 million, were sold. That included a refunding issue of $75 million, which resulted in gross savings in debt service of $9.5 million with a present value of $6.9 million.

A new financing team, headed by Goldman, Sachs & Co., was named to manage negotiated bond sales. To enhance the appeal of SRP bonds, the Project hosted a bond information program in October. Program participants met members of SRP's top management, received the latest information about items impacting on financing plans and inspected major facilities.

During the year, the Financial Services Group was reorganized. One result was a $1-million savings in insurance premiums for the Coronado station, brought about through increased emphasis on reducing risks and their accompanying costs.

Late in the year, the board raised both water and electric rates for 1979. Water charges increased by an average of 10 percent; this action was taken before the federal government established its voluntary anti-inflation program. Electric rates went up by an average of nine percent, and fall within anti-inflation guidelines.

Operating revenues climb

A strong economic environment provided the impetus for electric and water operating revenues to grow 8.6 percent since 1977 and reach $337.8 million.

SRP added more than 20,000 electric customers during 1978, 50.0 percent more than added in 1977. At year-end, the Project was serving nearly 290,000 customers.

Total electric revenues amounted to $333.3 million, compared with $305.6 million the previous year. Residential sales revenue increased from $134.5 million in 1977 to $154.8 million in 1978. Commercial and industrial revenues grew to $127.6 million in 1978, from $108.8 million in 1977. Revenues from all other retail classes declined 20 percent because heavy rainfall in the first half of the year curtailed the use of electric irrigation pumps.

Revenues from wholesale sales to other utilities were down 25 percent because hydroelectric generation available in California and the Pacific Northwest reduced the energy market. The supply of excess coal-generated electricity was limited due to growth in SRP loads and outages of large generating units.

In addition, water revenues dropped 18.9 percent because weather conditions reduced the demand for pumped irrigation water. Most water came from the Project's reservoir supply, which is provided at lower rates.

Operating expenses also increase

Project operating expenses totaled $246.9 million in 1978, compared with $220.4 million in 1977. Fuel and purchased-power expenses amounted to $96.5 million, up $11.2 million from the previous year. Most of the additional expenses were a result of an increase in the price and quantity of purchased power required. A series of forced outages of major generating units resulted in heavy reliance on oil-fired generation and emergency purchases.

Maintenance and depreciation expenses totaled $60.0 million, compared with $55.4 million in 1977. Expenses of tax and tax equivalents amounted to $38.3 million. Other operating expenses, including labor, materials, supplies and services totaled $52.1 million.

Debt service coverage

Funds available for debt service increased to $171.8 million in 1978 compared with $163.2 million in 1977. The debt service coverage ratio for the year was 1.65 compared with 1.77 for 1977.

Net financing costs, less allowances for funds used during construction, were $24.7 million in 1978, compared with $37.5 million in 1977.

Net revenues improve

Net revenues for 1978 reached $65.8 million, compared with $53.2 million in 1977. Net revenues remained at about 3.5 percent of gross plant investment. Net revenues are used to finance increases in working capital requirements and to help pay for construction and improvement of facilities.

SRP's gross plant investment totaled $1.9 billion in 1978, compared with nearly $1.5 billion in 1977.

Combined statement of net revenues

Salt River Project Agricultural Improvement and Power District
and its agent, Salt River Valley Water Users' Association

For the years ended December 31, 1978 and 1977

	1978	1977
Operating Revenues:		
Electric	$333,328,963	$305,620,727
Water and irrigation	4,435,320	5,466,506
Total operating revenues	$337,764,283	$311,087,233
Operating Expenses:		
Power purchased	$ 23,449,320	$ 17,766,614
Fuel used in electric generation	73,049,643	67,486,314
Other operating expenses	52,051,380	45,427,955
Maintenance	29,201,129	24,628,415
Depreciation and amortization (Note 1)	30,806,303	30,818,245
Taxes and tax equivalents (Note 6)	38,339,321	34,256,598
Total operating expenses	$246,897,096	$220,384,141
Net Operating Revenues	$ 90,867,187	$ 90,703,092
Financing Costs:		
Interest on bonds at coupon rates	$ 88,125,401	$ 76,804,743
Amortization of bond discount	953,344	818,787
Amortization of bond issue expense	211,024	184,259
Amortization of loss on defeased debt	900,828	247,049
Interest on other obligations	1,796,732	1,627,024
Interest earned on investments and deposits	(25,059,571)	(17,601,737)
Net financing costs	$ 66,927,758	$ 62,080,125
Less - Allowance for funds used during construction (Note 1)	(42,182,978)	(24,628,962)
Financing costs less allowance for funds used during construction	$ 24,744,780	$ 37,451,163
Other Deductions, net	$ 329,611	$ 43,359
Net Revenues for the Year	$ 65,792,796	$ 53,208,570

The accompanying notes to combined financial statements are an integral part of this statement.

Combined balance sheet

Salt River Project Agricultural Improvement and Power District
and its agent, Salt River Valley Water Users' Association

For the years ended December 31, 1978 and 1977

Assets

	1978	1977
Utility Plant, at original cost (Notes 1, 2, 3 and 4):		
Plant in service -		
Electric	$ 891,865,212	$ 842,364,849
Irrigation	66,140,557	64,459,472
General	44,467,905	40,826,678
Total plant in service	$1,002,473,674	$ 947,650,999
Less - Accumulated depreciation on plant in service	254,019,256	222,905,186
	$ 748,454,418	$ 724,745,813
Construction work in progress	909,665,676	525,868,827
	$1,658,120,094	$1,250,614,640
Segregated Funds, consisting of cash, U.S. Government obligations and bankers' acceptances set aside in accordance with resolutions of bond issues:		
Debt service funds, excluding $47,155,910 in 1978 and $38,855,641 in 1977 for payment of accrued interest (Note 9)	$ 118,487,456	$ 105,070,095
Construction funds	490,559	50,346,380
	$ 118,978,015	$ 155,416,475
Current Assets:		
Cash	$ 523,799	$ 340,639
Temporary investments, at cost, held primarily for construction	119,937,559	146,454,908
Deposit in debt service fund for payment of accrued interest on bonds	47,155,910	38,855,641
Receivable on sale of plant	—	47,480,043
Trade and other accounts receivable, less reserves of $1,335,000 in 1978 and $1,319,000 in 1977 for doubtful accounts	38,620,953	31,207,710
Fuel stocks, at average cost	15,221,540	23,006,012
Materials and supplies, at average cost	14,925,962	13,139,369
Prepayments, interest receivable and other	8,387,349	7,216,654
	$ 244,773,072	$ 307,700,976
Other Assets:		
Nonutility plant, less accumulated depreciation of $639,000 in 1978 and $688,000 in 1977	$ 3,261,916	$ 1,703,797
Unamortized loss on defeased debt (Note 1)	24,907,334	19,169,291
Bond expense being amortized (Note 1)	4,062,047	3,331,547
Miscellaneous deferred charges	14,821,333	11,975,078
	$ 47,052,630	$ 36,179,713
	$2,068,923,811	$1,749,911,804

Capitalization and Liabilities

	1978	1977
Long-Term Debt (Note 9):		
General obligation bonds	$ 254,227,292	$ 266,722,018
Electric system revenue bonds	1,386,724,785	1,147,765,203
Obligations to U.S. Government	12,690,968	12,337,937
Other obligations	2,371,230	1,445,133
	$1,656,014,275	$1,428,270,291
Accumulated Net Revenues, invested principally in utility plant:		
Balance beginning of year	$ 210,890,658	$ 157,682,088
Net revenues for the year	65,792,796	53,208,570
Balance end of year	$ 276,683,454	$ 210,890,658
Total capitalization, consisting of long-term debt and accumulated net revenues	$1,932,697,729	$1,639,160,949
Current Liabilities, excluding $16,132,000 in 1978 and $15,688,000 in 1977 representing current portion of long-term debt which is to be paid from segregated funds:		
Accounts payable	$ 50,635,742	$ 41,072,214
Accrued taxes and tax equivalents (Note 6)	17,874,394	14,532,244
Accrued interest	47,155,910	38,855,641
Customers' deposits	5,255,039	4,133,721
Other current and accrued liabilities	6,572,167	4,154,526
	$ 127,493,252	$ 102,748,346
Deferred Credits and Reserves:		
Irrigation assessments levied for subsequent year	$ 3,192,548	$ 2,855,670
Advances for construction	422,902	410,029
Other	5,117,380	4,736,810
	$ 8,732,830	$ 8,002,509
Commitments and Contingencies (Notes 3, 5, 6, 7 and 8)		
	$2,068,923,811	$1,749,911,804

The accompanying notes to combined financial statements are an integral part of this balance sheet.

Combined statement of sources of funds for additions to utility plant

Salt River Project Agricultural Improvement and Power District
and its agent, Salt River Valley Water Users' Association

For the years ended December 31, 1978 and 1977

	1978	1977
Gross Additions to Utility Plant, excluding allowance for funds used during construction	$406,124,480	$229,922,827
Funds Generated From Operations:		
Net revenues for the year	$ 65,792,796	$ 53,208,570
Add - Depreciation and other charges not requiring current funds	34,969,032	33,922,150
Deduct - Allowance for funds used during construction not providing current funds	(42,182,978)	(24,628,962)
Total funds generated from operations before retirement of debt	$ 58,578,850	$ 62,501,758
Less - Repayment of long-term debt	(15,392,937)	(15,303,768)
Net funds generated from operations	$ 43,185,913	$ 47,197,990
Funds Obtained From Financing:		
Proceeds of bond issues, less defeased bonds	$239,587,883	$253,791,084
Advances from U.S. Government for rehabilitation of irrigation plant	1,235,968	598,752
Contributions in aid of construction	7,898,168	8,043,068
Borrowings, net of repayments	926,097	(1,000,000)
Total funds obtained from financing	$249,648,116	$261,432,904
Other -		
(Increase) in segregated funds set aside for debt service	(13,417,361)	(17,732,131)
Decrease in segregated funds set aside for construction	49,855,821	46,801,431
(Increase) decrease in temporary investments held primarily for construction	26,517,349	(40,364,853)
Net funds obtained from financing	$312,603,925	$250,137,351
Changes in Other Items Affecting Funds:		
(Increase) decrease in receivable on sale of plant	$ 47,480,043	$ (47,480,043)
(Increase) in unamortized loss on defeased debt	(6,638,871)	(19,416,340)
Increase in accounts payable	9,563,528	15,610,711
(Increase) in accounts receivable	(7,413,243)	(10,994,480)
(Increase) decrease in fuel stocks and materials and supplies	5,997,879	(9,714,836)
(Increase) in deposits for payment of accrued interest on bonds	(8,300,269)	(5,374,274)
Increase in accrued interest	8,300,269	5,372,218
(Increase) decrease in cash	(183,160)	59,053
Change in other assets and liabilities, net	1,528,466	4,525,477
Net change in other items	$ 50,334,642	$ (67,412,514)
Funds Used for Additions to Utility Plant	$406,124,480	$229,922,827

The accompanying notes to combined financial statements are an integral part of this statement.

Notes to combined financial statements

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Principles Underlying Combined Statements

The combined financial statements include the accounts of the Salt River Project Agricultural Improvement and Power District ("District") and the accounts of its agent, the Salt River Valley Water Users' Association, together referred to as the Salt River Project, and a wholly owned subsidiary, Salt River Generating Company. All significant intercompany transactions have been eliminated.

(b) Utility Plant, Depreciation and Maintenance

The accounting records of Salt River Project are maintained substantially in accordance with the Uniform System of Accounts prescribed for electric utilities by the Federal Energy Regulatory Commission. Utility plant is stated at the historical cost of construction. Construction costs include labor, materials, services purchased under contract, and allocations of indirect charges for engineering, supervision, transportation, and administrative expenses.

An allowance for funds used to finance construction work in progress is capitalized as part of the electric and general plant. This allowance is deducted from net financing costs in the combined statement of net revenues and added to utility plant. Capitalization rates of 7½% and 6½% were used in 1978 and 1977, respectively.

Depreciation expense is computed on the straight-line basis over estimated useful lives of the various classes of plant. Rates in effect during the years 1978 and 1977 resulted in provisions approximating 3.46% for 1978 and 3.59% for 1977 on the average cost of depreciable electric plant, and 1.93% for 1978 and 1.94% for 1977 for depreciable irrigation plant. When property representing a retirement unit is replaced, removed, or abandoned, the cost of such property is credited to the appropriate utility plant account, and such cost together with removal costs less salvage is charged to accumulated depreciation.

The Project charges to maintenance expense the cost of labor, materials, and other expenses incurred in the repair, restoration of condition and replacement of minor items of property.

(c) Bond Expense

Bond discount, premium, and bond issue expense are being amortized over the terms of the related bond issues.

(d) Unamortized Loss on Defeased Debt

In April 1978 and August 1977 electric system revenue bonds were sold. Portions of the proceeds of these bonds were used to defease $210,000,000 of the outstanding electric system revenue bonds. These defeasances resulted in gross savings in debt service over the lives of the new issues of $32,300,000. The combined financing costs of the defeasances were $26,055,000. The Board of Directors approved deferral of the financing costs and their amortization over the lives of the April 1978 and August 1977 issues.

(e) Employees' Retirement Plan

The Project has a retirement plan covering substantially all employees. The plan is funded entirely from employers' contributions and the earnings of the invested assets. The estimated unfunded past service liability, as determined by the plan's actuary using the "entry age normal cost" valuation method, with frozen initial liability, was $9,863,491 as of July 1, 1978. This amount is being funded and amortized over a period ending in 2008. The employers' contributions to this plan totaled $5,970,882 in 1978 and $5,350,555 in 1977.

At July 1, 1978, the plan's assets exceeded the actuarially computed value of the vested benefits at the same date.

(f) Revenues

Meters for residential, commercial and small industrial customers are read cyclically and sales recorded only when billed. This system of billing results in earned but unbilled revenues which amounted to $8,956,000 at December 31, 1978, and $9,450,000 at December 31, 1977. For large industrial customers, meters are read near month-end and billings recorded on the accrual basis. Electric revenue billings are adjusted periodically for changes in costs of fuel and purchased power. Revenues from water and irrigation operations are recorded when earned.

(2) POSSESSION AND USE OF UTILITY PLANT

The United States of America retains a paramount right or claim in the Salt River Project which arises from the original construction and operation of the Project's facilities as a Federal Reclamation Project. The Project's right to the possession and use of, and to all revenues produced by, these facilities is evidenced by contractual arrangements with the United States.

(3) CONSTRUCTION PROGRAM:

Balances shown for construction work in progress represent expenditures for new facilities required to serve anticipated customer needs, and consist of:

	December 31	
	1978	1977
Electric generating facilities	$828,370,921	$450,324,298
Transmission and distribution	75,348,735	68,164,647
Irrigation plant	3,247,479	3,832,230
Other construction	2,698,541	3,547,652
Total	$909,665,676	$525,868,827

Construction expenditures planned for 1979 approximate $400 million.

At December 31, 1978, substantial commitments had been entered into for delivery of materials and services on construction projects. In addition, various firm commitments exist under coal and fuel oil supply contracts.

Notes *(Continued)*

(4) INTEREST IN JOINTLY OWNED ELECTRIC UTILITY PLANTS:

The Salt River Project has entered into various agreements with other electric utilities for the joint ownership of electric generating and transmission facilities. Each participating owner in these facilities must provide for and furnish the financing for its ownership share. The following schedule reflects the Project's ownership interest (at cost) in jointly owned electric utility plant at December 31, 1978.

		In Millions		
Plant Name	Ownership Share %	Plant in Service	Accumulated Depreciation	Construction Work in Progress
Four Corners (New Mexico)	10.0	$ 20.6	$ 6.0	$ 2.2
Mohave (Nevada)	10.0	30.1	6.9	1.7
Navajo (Arizona)	21.7	199.3	23.1	.2
Hayden (Colorado)	80.0	101.4	8.6	.2
Coronado (Arizona)	70.0	22.0	-	444.8
Craig (Colorado)	29.0	2.3	-	161.2
Palo Verde (Arizona)	29.1	-	-	239.0
		$375.7	$44.6	$849.3

Salt River Project's share of direct expenses of the jointly owned plants is included in the corresponding operating expenses on the attached "Combined Statement of Net Revenues."

(5) ENVIRONMENTAL LITIGATION:

Various pending litigation or administrative proceedings involving environmental matters could affect interests owned by Salt River Project in present generating facilities and in proposed generating facilities. In general, these lawsuits seek to impose higher air quality standards for generating plants. If ultimately decided adversely to the interest of Salt River Project, the outcome of the lawsuits could result in increased construction costs, increased future operating costs, and a possible loss in the operational reliability of certain generating plants. All of these effects would increase the costs to be passed on to customers through increased electric rates.

(6) PROPERTY VALUATION LITIGATION:

Salt River Project makes voluntary contributions to taxing bodies in lieu of payment of property taxes. The Department of Revenue of the State of Arizona has filed lawsuits requesting increases in the values used to compute the voluntary contributions for the years 1970 through 1974.

The general effect of the claims made under the lawsuits would be to increase the contributions for the years in dispute by a total of approximately $3,650,000. In 1973, in connection with a portion of the lawsuits, the Superior Court of Arizona granted a summary judgment in favor of Salt River Project. This summary judgment was later reversed in part in appellate decisions within Arizona, and this reversal was appealed to the United States Supreme Court which denied jurisdiction. The claims must now be litigated in Superior Court with the decision of that court possibly subject to the appellate process.

In 1978, the Department of Revenue filed another lawsuit in Superior Court contesting the 1978 valuation set by the Arizona Board of Property Tax Appeals. The effect of this claim would be to increase the contribution for 1978 by $3,100,000.

Under Arizona law, the amount of each voluntary contribution made by Salt River Project is subject to review and approval, or disapproval, by the Secretary of the Interior of the United States of America. In the opinion of legal counsel, any additional contributions required as a result of the above litigation would be subject to the approval or disapproval of the Secretary prior to payment.

If any liability were to result from this litigation, management expects that the amount of such liability would be recovered when paid through increased rates collected from electric customers.

(7) NAVAJO TAX LITIGATION:

The Navajo Tribe has created a Tax Commission which claims authority to tax facilities on the Navajo Indian Reservation. The Tribe has adopted a possessory interest tax and a business activity tax on certain facilities and operations on the Reservation, and the District is informed that such taxes are intended to apply to the Navajo and Four Corners projects. The District is unable to estimate the magnitude of the possessory interest tax because of its inability to interpret the way the tax is to be calculated. The District estimates that the business activity tax, if upheld by the courts, could expose it to claims approximating $4.6 million per year. The District and other co-owners of the Navajo and Four Corners projects have filed actions in the Federal District Court for Arizona and New Mexico contesting the validity and imposition of the possessory interest tax, and intend similar action with regard to the business activity tax. The District has appealed a decision from Federal District Court for Arizona upholding the right of the Tribe to impose the possessory interest tax to the Ninth Cicruit Court of Appeals.

The Navajo Tribal Council has adopted resolutions which, if valid, require permits and the quarterly payment of taxes for emissions of sulphur at rates which commence at $.15 per lb. the first year and increase annually to $.75 per lb in the fifth year. The District and other co-owners of the Navajo and Four Corners projects have filed actions in Federal District Court for Arizona and New Mexico. The tax will become effective subsequent to either approval of the Secretary of the Interior or a finding by the Secretary that such approval is not required. If such tax is upheld by the courts, the District could be exposed to claims approximating $3 million in the first year and increasing to $15 million in the fifth year and each year thereafter.

(8) OTHER LITIGATION:

Principally as a result of certain flooding in the early 1970's various lawsuits have been filed against Salt River Project alleging that the Project has a responsibility in regard to flood control and a liability in regard to flood damage. The ultimate liability, if any, is not determinable, but management expects that a significant portion of any liabilities which might result from flood damage claims will be covered by insurance.

(9) LONG-TERM DEBT:

Bonds outstanding are general obligation bonds and electric system revenue bonds. In all years to date, net electric revenues have been more than sufficient to meet all debt service requirements.

General obligation bonds are a lien upon the real property included in the District and are additionally secured by a pledge of revenues from the operation of the electric system. If the net electric revenues, as defined in the bond resolutions, are not sufficient to meet the principal and interest payments, the bonds and interest are payable from a levy of taxes on the real property.

Electric system revenue bonds are secured by a pledge of, and a lien on, the revenues of the electric system after deducting "operating expenses," as defined in the bond resolutions, subject to prior liens of general obligation bonds and amounts due the United States. In all years to date electric revenues, after deducting "operating expenses," as defined in the bond resolutions, have been more than sufficient to meet all debt service requirements.

Long-term debt outstanding at December 31, 1978 and December 31, 1977, was as follows:

	Interest Rate	Issued In Year	Outstanding 12/31/78	Outstanding 12/31/77	Future Maturities
General Obligation Bonds:					
Issue No. 5	2-1/2	1951	$ 1,500,000	$ 2,000,000	1979-80
Issue No. 6	2-3/4 to 3-5/8	1953	6,500,000	7,500,000	1979-82
Issue No. 7	3.2 to 3.4	1956	6,745,000	6,995,000	1979-87
Issue No. 8	3.6 to 3-5/8	1959	3,520,000	3,660,000	1979-87
Issue No. 9	1 to 4-1/4	1960	20,595,000	21,745,000	1979-92
Issue No. 10	1 to 3.6	1962-65	14,010,000	14,875,000	1979-94
Issue No. 11	3.4 to 3-1/2	1965	9,800,000	10,400,000	1979-87
Issue No. 12	3 to 5	1968-69	33,700,000	35,350,000	1979-99
Issue No. 13	4 to 5	1969	7,200,000	7,550,000	1979-99
Issue No. 14	3-1/2 to 6	1970-72	153,400,000	159,700,000	1979-2003
			$ 256,970,000	$ 269,775,000	
Unamortized bond discount			(2,742,708)	(3,052,982)	
Total general obligation bonds outstanding			$ 254,227,292	$ 266,722,018	
Electric System Revenue Bonds:					
1973 Series A	5 to 6-1/2	1973	$ 72,505,000	$ 73,380,000	1979-2010
1973 Series B	5 to 6-1/2	1973	73,380,000	74,210,000	1979-2011
1974 Series A	5.7 to 7.2	1974	90,000,000	90,000,000	1983-2012
1974 Series B	6.1 to 7.6	1974	50,000,000	50,000,000	1983-2012
1975 Series B	7.0 to 7.6	1975		75,000,000	
1976 Series A	5.0 to 7.2	1976	100,000,000	100,000,000	1985-2016
1976 Series B	4.7 to 6-5/8	1976	140,000,000	140,000,000	1984-2016
1976 Series C	6.0 to 6-3/4	1976	40,000,000	40,000,000	1982-2016
1976 Series D	4.0 to 6.4	1976	125,000,000	125,000,000	1980-2016
1977 Series A	3-3/4 to 6-1/8	1977	125,000,000	125,000,000	1980-2017
1977 Series B	4-3/4 to 5.9	1977	155,915,000	155,915,000	1989-2015
Refunding 1977 Series C	3.8 to 5.8	1977	115,000,000	115,000,000	1980-2017
1978 Series A	4.4 to 6.2	1978	125,000,000		1981-2018
1978 Series B	5 to 7	1978	100,000,000		1981-2018
1978 Series C	5.7 to 6.5	1978	92,900,000		1981-2018
			$1,404,700,000	$1,163,505,000	
Unamortized bond discount			(17,975,215)	(15,739,797)	
Total electric system revenue bonds outstanding			$1,386,724,785	$1,147,765,203	
Total bonds outstanding			$1,640,952,077	$1,414,487,221	
Obligations to U.S. Government for irrigation plant	None	1935-78	12,690,968	12,337,937	1979-2003
Equipment contracts	7-1/2 & 7.77	1975-78	2,359,758	1,422,312	1979-83
Other obligations	None	1950	11,472	22,821	1979
Total long-term debt			$1,656,014,275	$1,428,270,291	

Notes *(Continued)*

The annual maturities of bonds and other long-term debt outstanding as of December 31, 1978 due in each of the years 1979 through 1983 are $16,645,000; $19,510,000; $21,922,000; $22,800,000 and $21,489,000, respectively.

Interest and amortization of discount on the various issues outstanding during the year resulted in an effective rate of 6.04% for 1978. This rate approximates 6.25% over the remaining terms of the bonds.

The debt service portion of segregated funds includes $22,463,000 at December 31, 1978, and $18,666,000 at December 31, 1977, restricted for operating reserve requirements under bond resolutions.

At December 31, 1978, electric system revenue bonds totaling $380,000,000 principal amount were authorized, but unissued. Electric system refunding revenue bonds not to exceed $115,000,000 principal amount were also authorized, but unissued.

In March 1979, the District plans to issue Electric System Revenue Bonds (1979 Series A) for $110,000,000.

(10) LINE OF CREDIT:

The District has a line-of-credit agreement with 13 banks, which provides for a maximum commitment of $100,000,000 with interest on borrowings at a rate equal to 60% of the banks' prime rate as established from time to time by the lead bank. No compensating balances nor commitment fees are required under the line-of-credit. The current agreement terminates on October 16, 1979. The line-of-credit borrowings are borrowed in the name of and payable from the General Fund and rank junior to payments required for the Prior Lien Bonds and the Revenue Bonds. During 1978, $60,000,000 was borrowed under a previous line-of-credit agreement at an average annual interest rate of 4.95%. At December 31, 1978, there are no outstanding borrowings. On January 2, 1979, the District borrowed the full $100,000,000 at an initial interest rate of 7.05% repayable in full on or before October 16, 1979.

(11) IRRIGATION AND WATER OPERATIONS:

The expenses, including depreciation, for irrigation and water operations exceeded the assessments, delivery fees, and other revenues therefrom by approximately $7,507,000 in 1978 and $9,462,000 in 1977. These amounts do not include expenditures for additions and improvements to irrigation plant and for repayment of long-term debt.

Auditors' report

To the Board of Directors,
Salt River Project Agricultural Improvement and Power District, and
Board of Governors,
Salt River Valley Water Users' Association:

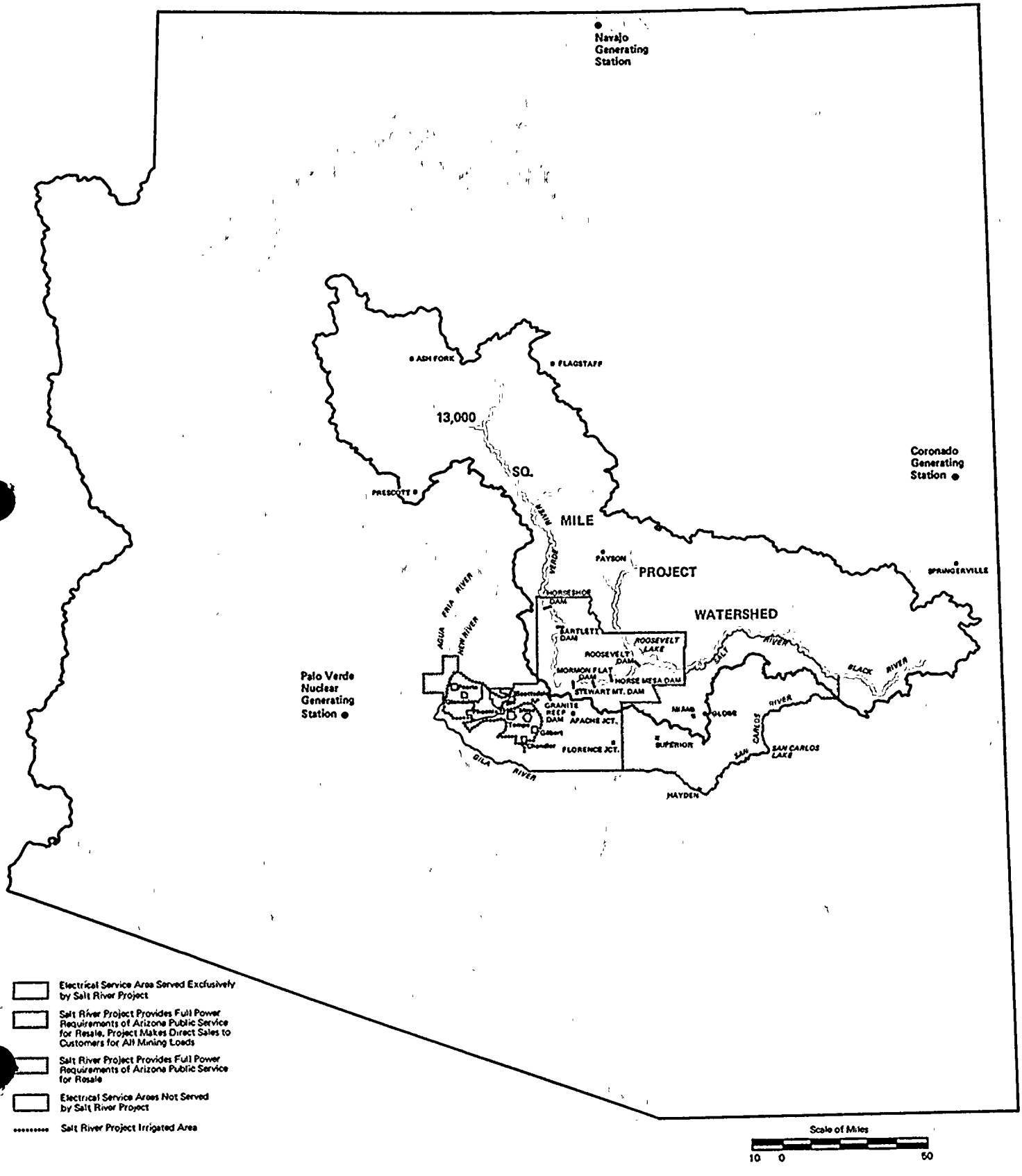
We have examined the combined balance sheet of SALT RIVER PROJECT AGRICULTURAL IMPROVEMENT AND POWER DISTRICT (a political subdivision of the State of Arizona) and its agent, SALT RIVER VALLEY WATER USERS' ASSOCIATION, together referred to as the SALT RIVER PROJECT, as of December 31, 1978, and December 31, 1977, and the related combined statements of net revenues and sources of funds for additions to utility plant for the years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

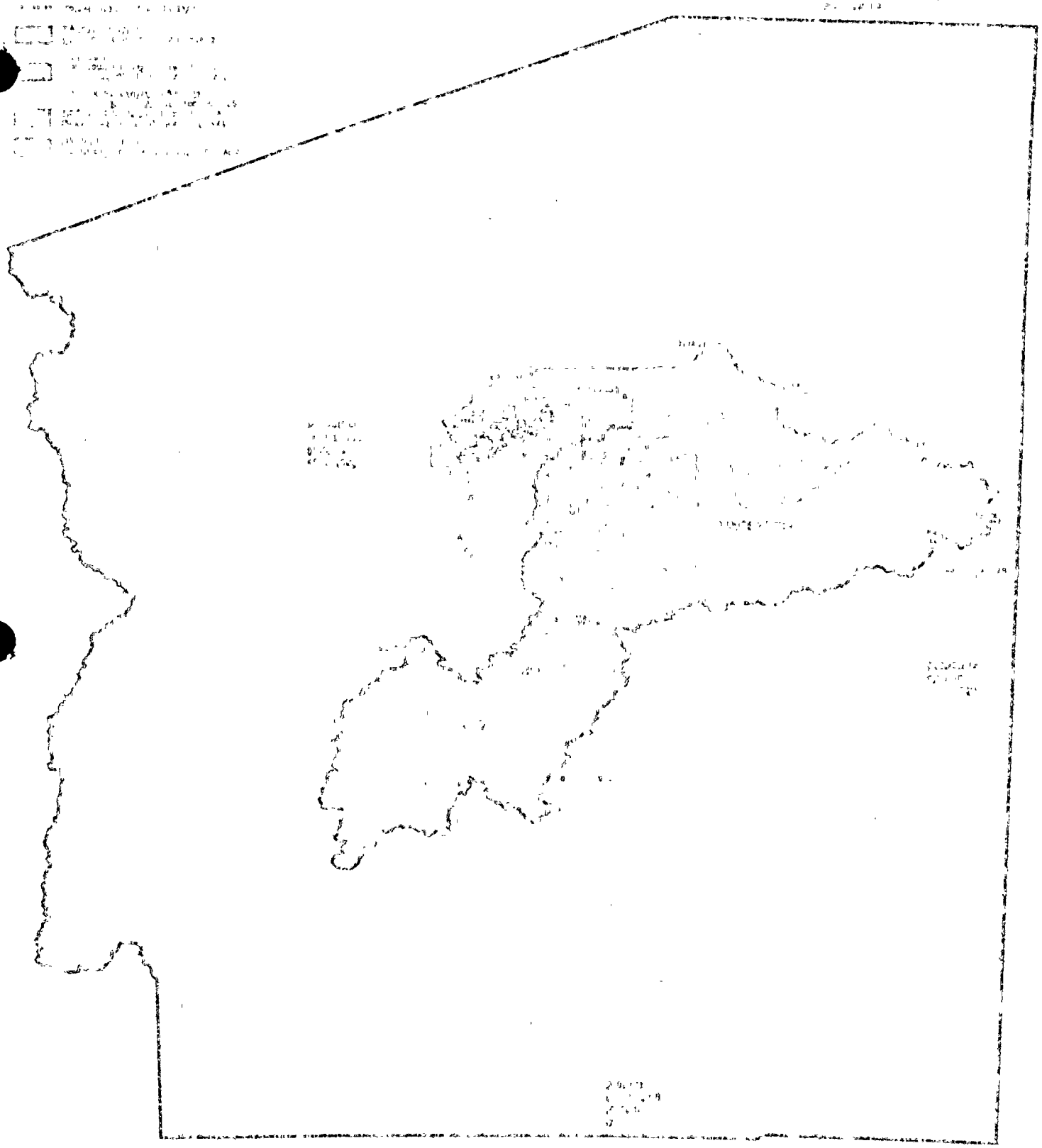
In our opinion, the financial statements referred to above present fairly the financial position of the Salt River Project as of December 31, 1978, and December 31, 1977, and the results of its operations and sources of funds for additions to utility plant for the years then ended, in conformity with generally accepted accounting principles consistently applied during the periods.

Arthur Andersen & Co.

Phoenix, Arizona,
February 15, 1979.

SALT RIVER PROJECT WATERSHED, IRRIGATED AREA AND ELECTRICAL SERVICE AREA





SAN LUIS RIVER PROJECT WATERSHED IMPROVEMENT AREA
AND
RECLAMATION SERVICE AREA

Officers, Board & Council

Elected Officers

Karl F. Abel
President

John R. Lassen
Vice President

Principal Officers and Other Executives

Jack Pfister
General Manager

Robert F. Amos
Deputy General Manager

Paul G. Ahler
Director, Human Resources

John D. Jacobs
Director, Information Systems

Roger B. Ludeman
Director, Operations Services

John R. McNamara
Associate General Manager, Power

Trent O. Meacham
Assistant General Manager, Power Construction & Maintenance

John O. Rich
Assistant General Manager, Power Operations

Stephen M. Chalmers
Director, Engineering Services

Reid W. Teeples
Associate General Manager, Water

Don L. Weesner
Assistant General Manager, Water

Leroy Michael Jr.
Assistant General Manager, Planning & Resources

R. W. Mason
Director, Project Planning

Carroll M. Perkins
Assistant General Manager, Financial Services

Kenneth J. Knauer
Treasurer

Don Parlett
Assistant General Manager, Marketing & Customer Services

Stanley E. Hancock
Assistant General Manager, Communications & Public Affairs

D. Michael Rappoport
Director, Governmental Affairs

Richard H. Silverman
Director, Law & Land

Paul D. Rice
Corporate Secretary

Consultants

Legal Advisers
Jennings, Strouss & Salmon

Auditors
Arthur Andersen & Co.

Consulting Engineers
Ford, Bacon & Davis Incorporated

Bond Counsel
Mudge Rose Guthrie & Alexander

Financial Consultant
Smith Barney, Harris Upham & Co. Incorporated

Board Members

The 10 members of the Board of Governors of the Salt River Valley Water Users' Association are elected biennially from among the shareholders of the Association.

The Board of Directors of the Salt River Project Agricultural Improvement and Power District consists of 12 members. One District board member is elected from each of the 10 SRP voting areas, and two members are elected at-large. Beginning with the election held in 1978, board members serve four-year terms, with half elected every two years. Two more at-large representatives will be added in 1980, bringing the total number of District board members to 14.

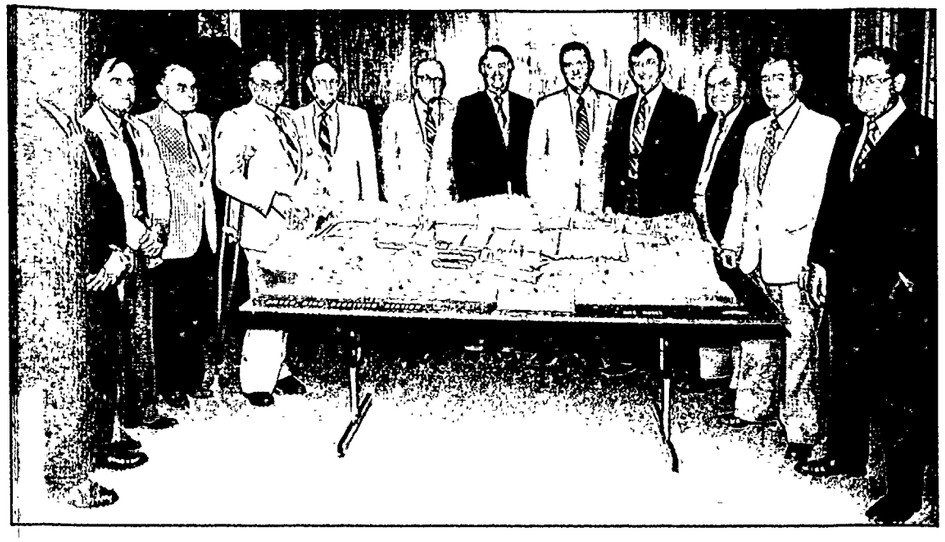
Board members establish the policies for the management and conduct of the Project's business affairs.

Council Members

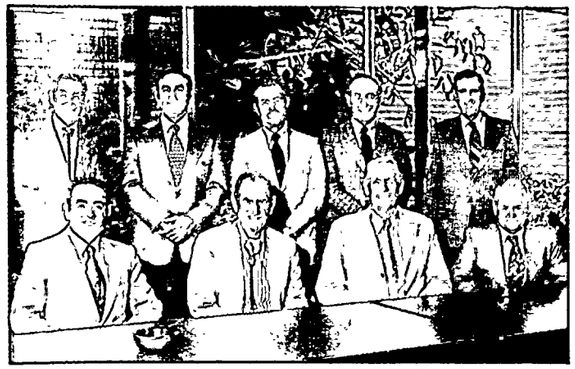
Three council members are elected for two-year terms from among the shareholders in each of the 10 district areas of the Salt River Valley Water Users' Association and from among the members of each of the 10 division areas of the Salt River Project Agricultural Improvement and Power District.

Beginning with the election held in 1978, District council members are elected to four-year terms with half the council seats up for election every two years.

The councils enact and amend bylaws relating to the management and conduct of SRP's business affairs.

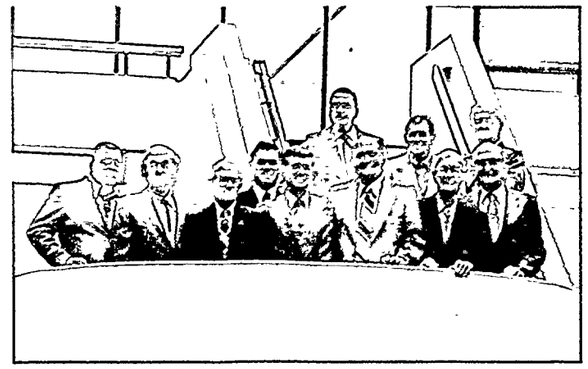


SRP Board members, left to right (district number follows Board member's name): Thomas P. Hurley, No. 6; Bill Rousseau, No. 3; John L. Burton Jr., at-large; Alex M. Conovaloff, No. 2; Thomas M. Owens Jr., No. 8; Gilbert R. Rogers, No. 4; Germain H. Ball, No. 1; William P. Schrader, No. 7; William W. Arnett, at-large; W. Larkin Fitch, No. 9; Tom Finley, No. 10; and John M. Williams Jr., No. 5.



SRP Council members, left to right, back row: Howard W. Lydic, District 1; Conrad Gingg, District 2; Elvin E. Fleming, District 3; C.C. Pendergast Jr., District 2; Marcel J. Boulais, District 2; front row: John E. Anderson, District 3; M.B. Brooks Jr., District 3; Emil Rovey, District 1; and Rudolph Johnson, District 1.

SRP Council members, left to right, back row: Edmund Navarro, District 5; Carl E. Weiler, District 5; James R. Marshall, District 6; James L. Diller, District 6; front row: Wiley R. Baker, District 4; Roy W. Cheatham, District 5; Ivy Wilson Jr., District 4; Dean W. Lewis, District 6; and Levi H. Reed, District 4.



SRP Council members, left to right, back row: Joe Bob Neeley, District 8; Dwayne E. Dobson, District 8; George B. Willmoth, District 7; front row: L. Max Pace, District 10; William H. Goettl, District 7; Olen Sharp, District 9; Orland R. Hatch, District 10; Martin Kempton, District 8; W. Curtis Dana, District 9; A. Warren Austin, District 7; and Otto B. Neeley, District 10. Not Shown: Robert W. Birchett, District 9.

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Salt River Project
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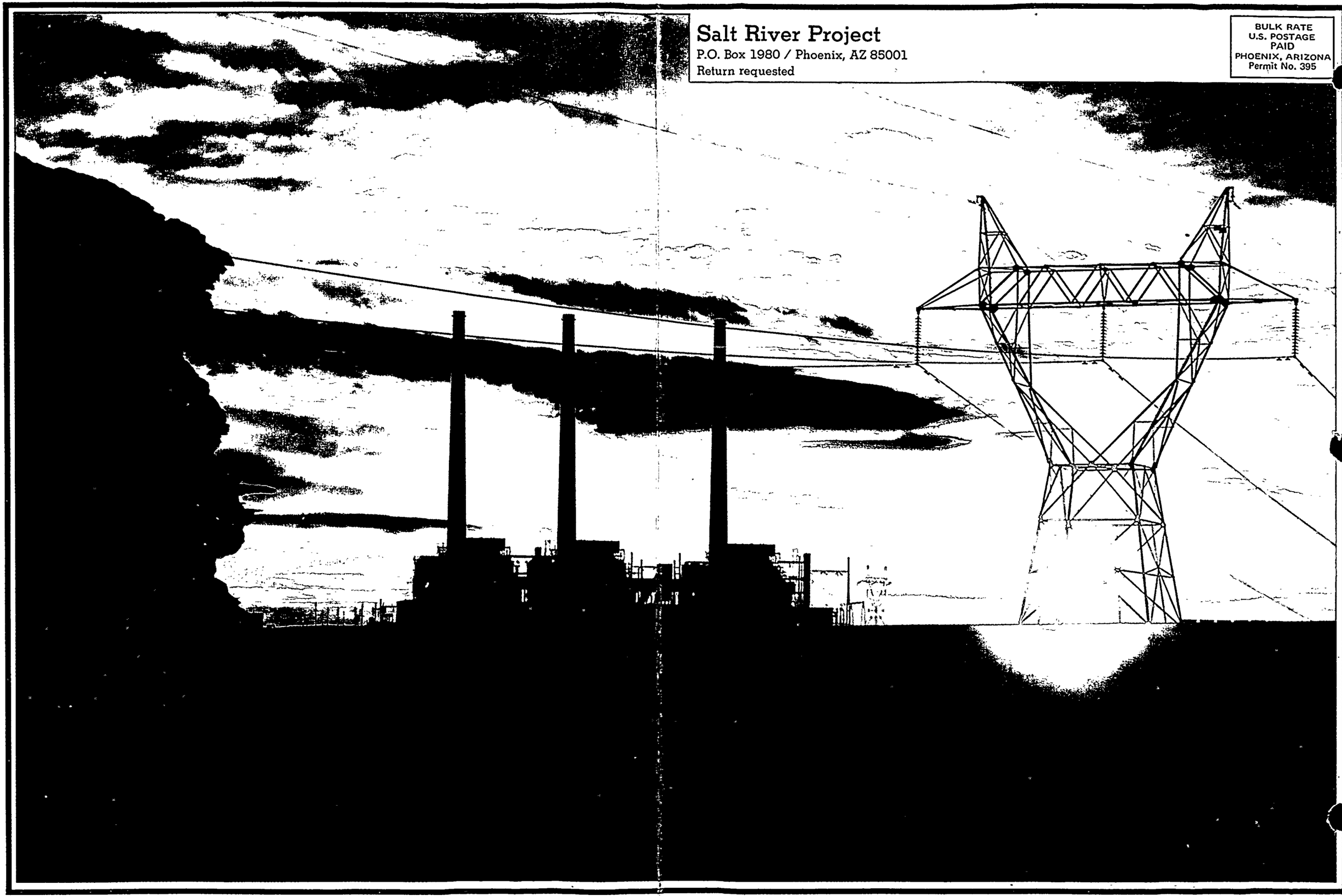


SECTION 5

GENERAL INFORMATION RESPECTING JOINT APPLICANT SOUTHERN CALIFORNIA EDISON COMPANY

(a) Name of joint applicant:

Southern California Edison Company

(b) Address of joint applicant:

2244 Walnut Grove Avenue
Post Office Box 800
Rosemead, California 91770

(c) Description of business of joint applicant:

Southern California Edison Company is an operating public utility engaged in the business of purchasing, generating, transmitting, distributing and selling electricity. Southern California Edison Company provides electric service in a 50,000 square mile area of central and southern California, which includes a population of more than 8 million people.

(d) (1) Not applicable.

(d) (2) Not applicable.

(d) (3) (i) State of incorporation and principal location:

Southern California Edison Company is a corporation duly organized and existing under and by virtue of the laws of the State of California. Its general offices are located at 2244 Walnut Grove Avenue, Rosemead, California.

(d) (3) (ii) Names, addresses and citizenship of directors and principal officers.

Directors of Southern California Edison Company

Name	Address
Jack K. Horton	Chairman of the Board and Chief Executive Officer Southern California Edison Company Post Office Box 800 Rosemead, California 91770
Roy A. Anderson	Chairman of the Board and Chief Executive Officer Lockheed Corporation Post Office Box 551 Burbank, California 91520
Norman Barker, Jr.	Chairman of the Board and Chief Executive Officer United California Bank Post Office Box 3666 Los Angeles, California 90051
Edward W. Carter	Chairman of the Board Carter Hawley Hale Stores, Inc. 550 South Flower Street, 12th Floor Los Angeles, California 90071
William B. Coberly, Jr.	President California Cotton Oil Corporation 626 Wilshire Boulevard, Room 508 Los Angeles, California 90017
Terrell C. Drinkwater	Retired Airline Executive 223 Chadbourne Avenue Los Angeles, California 90049
Walter B. Gerken	Chairman of the Board and Chief Executive Officer Pacific Mutual Life Insurance Co. 700 Newport Center Drive Newport Beach, California 92660
William R. Gould	President Southern California Edison Company Post Office Box 800 Rosemead, California 91770

Directors of Southern California Edison Company

Name	Address
Frederick G. Larkin, Jr.	Chairman of the Executive Committee Security Pacific National Bank Post Office Box 2097 Terminal Annex Los Angeles, California 90051
T. M. McDaniel, Jr.	Corporate Director and Consultant (Retired President, Southern California Edison Company) 650 Chester Avenue San Marino, California 91108
Dorothy W. Nelson, (Dr.)	Dean and Professor of Law University of Southern California Law Center University Park, Room 108 Los Angeles, California 90007
John V. Newman	President CBS-SONY California, Incorporated 4300 Etting Road Oxnard, California 93030
Gerald H. Phipps	President, Gerald H. Phipps, Incorporated Post Office Box 4387 Denver, Colorado 80204
Henry T. Segerstrom	Managing General Partner, C.J. Segerstrom and Sons 3315 Fairview Road Costa Mesa, California 92626
E. L. Shannon, Jr.	President and Chief Executive Officer Santa Fe International Corporation Post Office Box 1401 Orange, California 92668

Directors of Southern California Edison Company

Name	Address
H. Russell Smith	Chairman of the Board Avery International 415 Huntington Drive San Marino, California 91108
Richard R. Von Hagen	President Lloyd Corporation, Ltd. 9441 Olympic Boulevard Beverly Hills, California 90212

Principal Officers of Southern California Edison Company

Jack K. Horton	Chairman of the Board and Chief Executive Officer
William R. Gould	President
Howard P. Allen	Executive Vice President
H. Fred Christie	Senior Vice President and Chief Financial Officer
David J. Fogarty	Senior Vice President
A. Arenal	Vice President
G. J. Bjorklund	Vice President
J. H. Drake	Vice President
Joe T. Head, Jr.	Vice President
P. L. Martin	Vice President
A. L. Maxwell	Vice President and Comptroller
Edward A. Myers, Jr.	Vice President
William H. Seaman	Vice President
Robert E. Umbaugh	Vice President
G. E. Wilcox	Vice President

Principal Officers of Southern California Edison Company

John R. Bury	General Counsel
Michael L. Noel	Treasurer
J. C. Bobek	Secretary

The address of all of the foregoing principal officers of Southern California Edison Company is:

Post Office Box 800
Rosemead, California 91770

Each of the directors and principal officers is a citizen of the United States of America.

(d) (3) (iii) Southern California Edison Company is not owned, controlled, or dominated by an alien, a foreign corporation, or foreign government.

(d) (4) Southern California Edison Company is not acting as agent or representative of another person in respect of this joint application.

(e) See Section 1 (e) hereof.

(f) In accordance with 10CFR50, Appendix C, a copy of joint applicant Southern California Edison's 1978 Financial Report is attached hereto as Appendix 5A.

(g) (Not used)

(h) See Section 1 (h) hereof.

(i) The regulatory agencies which have jurisdiction over the rates and services of Southern California Edison Company are:

California Public Utilities Commission
Fifth Floor, State Building
San Francisco, California 94102

Federal Energy Regulatory Commission
Washington, D.C. 20426

News publications that circulate in the area in which the facility will be located are:

The Arizona Republic
120 East Van Buren
Phoenix, Arizona 85004

The Phoenix Gazette
120 East Van Buren
Phoenix, Arizona 85004

Buckeye Valley News
P.O. Box 217
Buckeye, Arizona 85326

News publications that circulate in Southern California Edison's service area include the following:

Los Angeles Times
Times Mirror Square
Los Angeles, California 90053

Herald-Examiner
1111 South Broadway
Los Angeles, California 90015

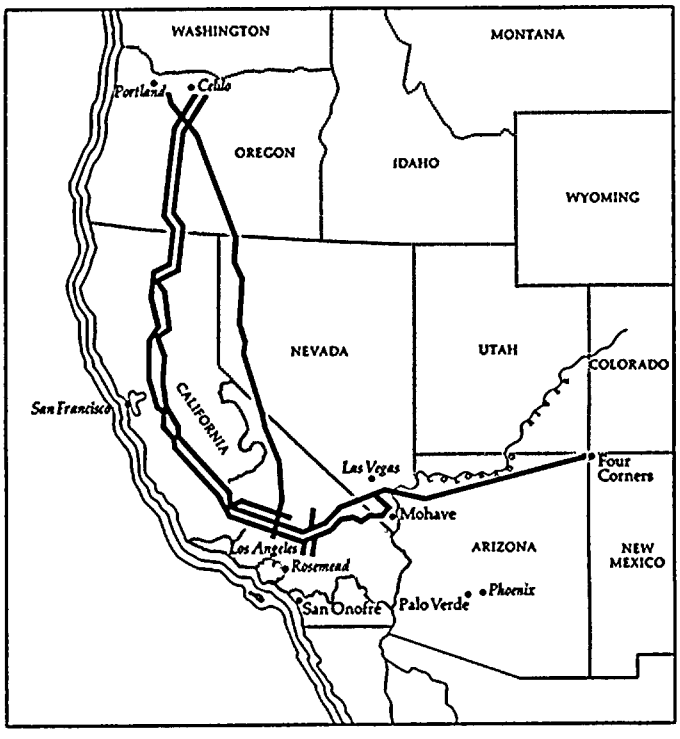
San Bernardino Sun
399 D. Street
San Bernardino, California 92401

(j) Not applicable.

APPENDIX 5A

SOUTHERN CALIFORNIA EDISON COMPANY 1978 ANNUAL REPORT

Southern California Edison Company



▫ *Service Territory*
— *Extra-High Voltage (EHV) Transmission Lines*

Southern California Edison Company provides electric service in a 50,000 square-mile area of Central and Southern California. This area includes some 800 cities and communities with a population of nearly eight million people.

Edison's gross investment in utility plant totals more than $6.8 billion. The installed Company-owned generating capacity at the end of 1978 was 13,156 megawatts of which 78% is accounted for by oil and gas-fired generating units. SCE's interest in coal-fired generating units accounts for another 13%, and 6% is in hydroelectric plants. The Company's 80% interest in a nuclear plant accounts for the remaining 3%. In addition, Edison had 1,547 megawatts of capacity under contract from other utility sources at year-end.

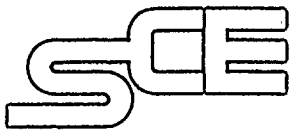
The Company, incorporated in 1909 under the laws of California, is a public utility and its retail operations are subject to regulation by the California Public Utilities Commission which has the power, among other things, to establish retail rates and to regulate security issues, accounting and depreciation. The Company's resale operations are subject to regulation by the Federal Energy Regulatory Commission as to rates on sales for resale, as well as to other matters including accounting and depreciation.

Under the recently enacted National Energy Act, the federal Department of Energy has been granted regulatory authority over certain aspects of energy conservation, solar energy development, power plant fuel use, coal conversion, public utility regulatory policy and natural gas pricing.

The Company's plant construction planning and siting are subject to the jurisdiction of the California Energy Commission. Edison also is subject to various governmental licensing requirements, to Securities and Exchange Commission filing and disclosure requirements, and to certain other federal, state and local laws and regulations, including those related to nuclear energy and nuclear plant construction, environmental protection, fuel supplies and land use.

Contents

1978 Annual Report

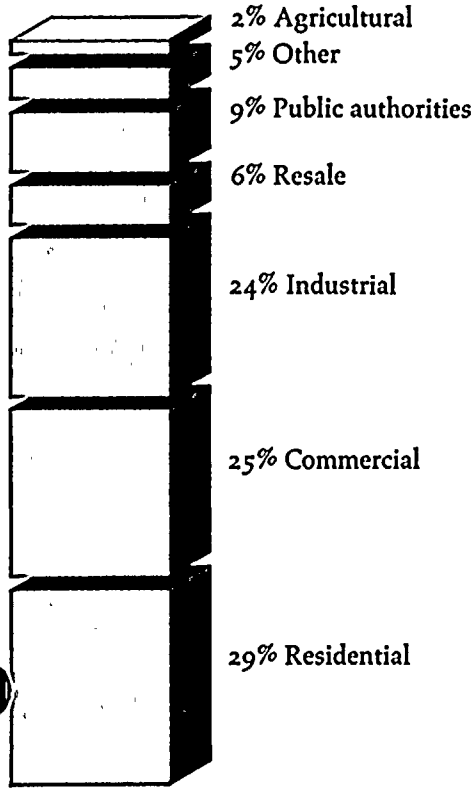


Southern California Edison Company

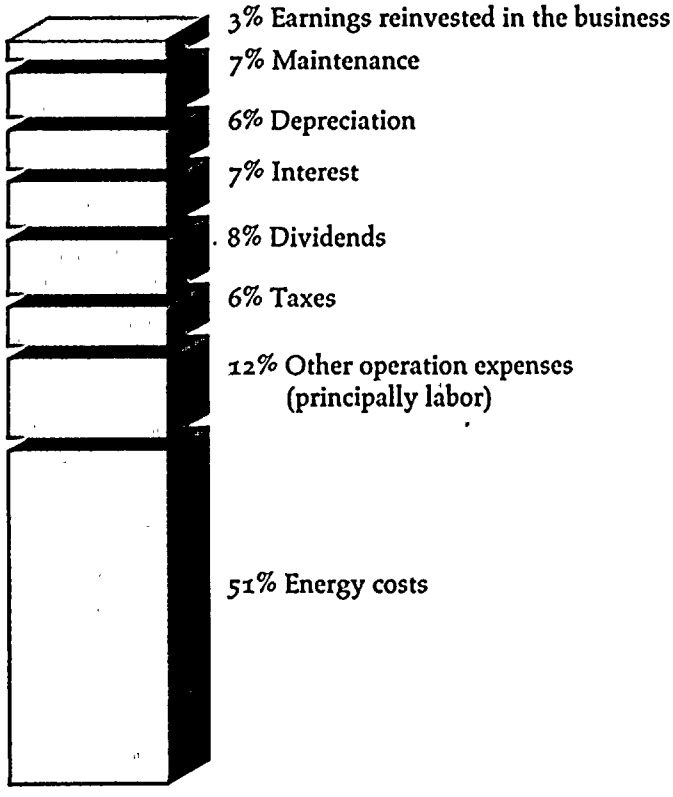
Highlights	1978	1977	% Change	% Five-Year Compound Growth
Earnings Per Share	$ 3.52	$ 3.80(a)	(7.4)	5.7
Common Dividends Paid Per Share (b)	$ 2.24	$ 1.92	16.7	7.5
Operating Revenues (000)	$2,328,798	$2,064,914	12.8	16.7
Operating Expenses (000)	$2,004,197	$1,734,192(a)	15.6	18.9
Energy Costs (000) (c)	$1,240,029	$1,040,091	19.2	29.2
Construction Expenditures (000)	$ 568,000	$ 500,000	13.6	12.5
Employees	13,505	13,266	1.8	(0.6)
Customers Served	2,986,545	2,900,856	3.0	2.6
Kilowatt-hour Consumption (000) (d)	55,637,381	54,153,851	2.7	1.3

(a) Restated. See Note 2 of the Notes to Financial Statements.
(b) On December 21, 1978, the Company's Board of Directors authorized an increase in the Common Stock quarterly dividend to $0.62 from $0.56 per share, effective with the January 31, 1979 payment, which is equivalent to $2.48 per share on an annual basis.
(c) Included in Operating Expenses.
(d) Excluding Special Contracts.

Source of Total Revenues: 1978



Distribution of Total Revenues: 1978



To Our More Than 180,000 Shareholders

The Company's operations in 1978 were highlighted by expanding efforts toward the development of new sources and methods of energy production, continuing emphasis on load management and energy conservation programs, and sustained efforts to improve productivity and management effectiveness. The year also featured timely action by the California Public Utilities Commission (CPUC) on the Company's request for a general rate increase.

The CPUC, operating under a new plan to reduce regulatory lag, authorized the Company a partial rate increase in July and a final increase in December which together are designed to produce approximately $124 million in increased revenues based on a 1979 test year. Other actions relating to the Tax Change Adjustment Clause procedure, discussed in the text of this Report, are expected to provide an additional $34 million in annual revenues.

The Company's authorized return on common equity was increased by the CPUC from 12.63% to 13.49%, which represents the first authorization by the CPUC of a rate of return on common equity in excess of 13% for an electric utility in California. In addition, for the first time in recent years, the new rates became effective at the beginning of the test year.

The increased rates and higher authorized return for 1979 are of particular importance because earnings per share for 1978 were $3.52, down from the $3.80 recorded (on a restated basis) in 1977. The lower earnings resulted primarily from increases in operating and money costs not covered by the rates in effect through most of the year, a greater number of common shares outstanding, and several extraordinary factors, including increased maintenance expense resulting from severe rain storms early in 1978 and the absence of the high level of drought-related energy sales to other utilities recorded in 1977.

Earnings for the fourth quarter of 1978 increased significantly over fourth quarter 1977 earnings, marking the first increase in quarterly earnings comparisons in five consecutive quarters. One factor contributing to the increased earnings per share was that this was the first calendar quarter fully affected by the partial rate increase granted in July.

Common Stock Dividend Raised

On December 21, 1978, the Board of Directors declared an 11% increase in the common stock quarterly dividend by raising the rate to 62 cents per share from the 56 cents established in December 1977. On an annual basis, this is equivalent to $2.48 per share, compared with the previous annual rate of $2.24 per share.

The Board's action represents the third dividend increase in the past two years and underscores the Company's continuing objective to provide returns to our common stock shareholders which, other things being equal, should tend to support a price of common stock at least equal to its book value. The Company has paid quarterly cash dividends on its common stock each year since 1910.

Improvement in Productivity and Management Effectiveness

We have intensified programs to improve management effectiveness and productivity in an effort to employ all of our resources more efficiently for the benefit of customers and shareholders alike. Specific areas of productivity improvement have been identified and action programs have been implemented. Progress will be reviewed on a continuing basis by Management.

The number of Edison customers now totals three million, an increase of 360,000 during the last five years, yet we serve them with 420 fewer employees than at year-end 1973 — a clear indicator of improved productivity.

Energy Management

It is important that our customers use electric energy more efficiently both to reduce the use of expensive low-sulfur fuel oil and to defer the need for some future plant facilities.

Since 1973, we have implemented more than 50 energy conservation and load management programs in our service territory. Our 1979 programs are expected to lower projected kilowatt-hour (KWH) consumption by more than three billion KWH on an annual basis. This would mean an annual savings of nearly five million barrels of fuel oil, the equivalent of approximately $80 million.

Our load management programs are designed to shift electric usage from periods of peak or high-use demand to periods of lesser demand. Our goal is to reduce projected peak demand by more than 600 megawatts by 1985, or enough capacity to serve about 375,000 residential customers. Such a reduction means lower capital expenditure requirements for new plant and a correspondingly reduced need for external financing.

Future Growth

As a result of energy management programs, the higher cost of electricity, and a revised economic outlook, we have reduced by nearly one-half our growth projections for peak demand and KWH consumption from the growth rates projected prior to the oil embargo in 1973. Our current long-range forecast is for annual growth of approximately 3½% for both peak demand and KWH consumption.

Our anticipated construction expenditures for the five-year 1979-83 period also have been reduced dramatically from the estimates made several years ago for this period. Presently, expenditures are projected at $2.8 billion for this period, which we believe is a financially manageable level.

We currently estimate approximately 650,000 new customers will be added to our electric system during the next 10 years, 600,000 of which are expected to be residential customers.

Our generating capacity under construction and current reserve margins are sufficient, we believe, to meet projected energy demands by our customers through 1984.

Outstanding Employee Effort

We acknowledge the outstanding display of employee dedication exhibited during the year, especially in performance of duty during a series of severe wind, lightning and rain storms. The storms were some of the worst in our Company's history, with approximately one-third of our three million customers experiencing electric service interruptions.

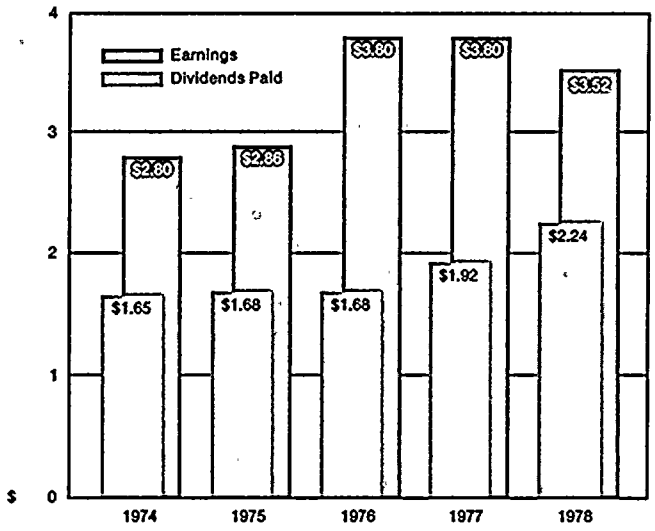
The storms were particularly challenging occurrences in our 1978 operations, but the hard work and experience of our employees, coupled with the cooperation and understanding of our valued customers, enabled us to repair damage and restore service in a timely and efficient manner.

William R. Gould
President

Jack K. Horton
Chairman of the Board

February 15, 1979

Earnings and Dividends Paid Per Share of Common Stock



SCE declared an 11% increase in the common stock quarterly dividend in December by raising the rate from 56 cents to 62 cents per share. This action, which is equivalent to $2.48 per share on an annual basis, represents the third dividend increase in the past two years and underscores the Company's continuing objective to provide adequate returns to its common stock shareholders.

SCE Installs Three Millionth Meter

Southern California Edison Company installed its three millionth electric meter on the system in September to become only the third electric utility in the United States to reach this milestone. During the year, the Company added 85,689 customers to the system.

Kilowatt-hour (KWH) consumption by Edison customers increased 2.7% during the year. Total consumption during the year, however, decreased to 57.0 billion KWH, down 1.2% from the 1977 level, as a result of the absence of the unusually high energy sales to drought-affected utilities recorded in 1977.

Residential consumption was up 7.6%, as compared with the previous year, while commercial usage gained 4.1% and industrial usage rose 1.6%. Consumption by other customer classifications — agricultural, public authorities, interdepartmental and resale (excluding special resale contracts) — decreased 4.0%.

Record Peak Set During Heat Wave

Despite the long-term trend of conservation by customers, a record peak demand of 11,997 megawatts (MW) was set on September 25 during a period of extraordinarily hot temperatures. The new peak represents a 6.7% increase over the peak recorded in 1977. The average annual growth in peak demand over the past five years, including the 1978 peak, was 3.2%, which is in line with long-term projections.

Conservation Programs Expanded

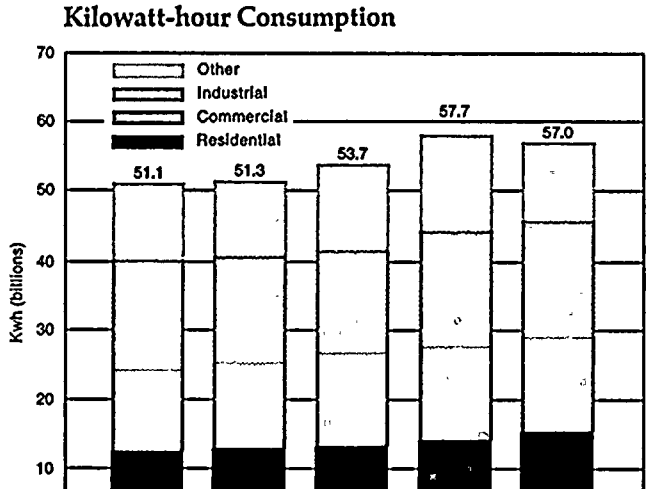
During the year, SCE continued to develop and expand programs designed to encourage more efficient use of electric energy by all customer classes — residential, commercial, industrial, public authorities, and agricultural.

The programs include individualized conservation advice letters for homeowners, insulation of electric water heaters, a conservation display center, water pumping efficiency tests, conservation kits for school children, more energy-efficient lighting for commercial, industrial and agricultural customers, and energy audits for all customers.

During 1978, a new customer bill, designed to encourage energy conservation, was developed to provide customers with more detailed records of their energy usage, average daily costs and comparisons with their usage a year ago. The first mailing of the new bill was made to residential and commercial customers in December. Large industrial, agricultural and street lighting accounts are expected to be converted to the new billing format by the end of 1979.

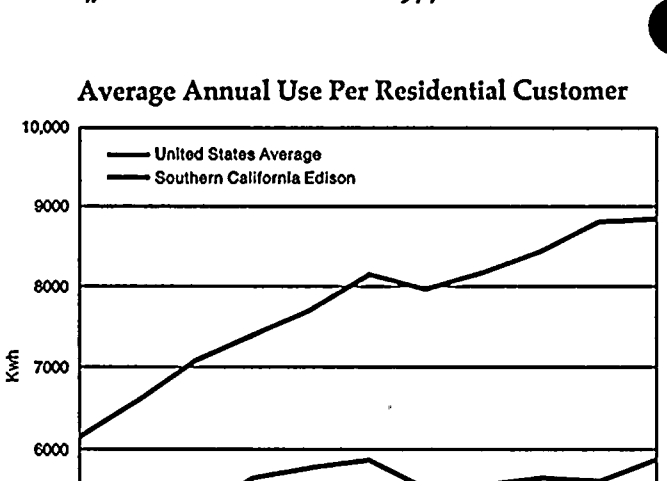
The Company is participating in a special test program, in cooperation with government agencies, to help low-income residential customers save energy and at the same time reduce their electric bills.

Kilowatt-hour Consumption



Kilowatt-hour consumption by Edison customers increased 2.7% during the year. Total consumption in 1978, however, decreased 1.2% reflecting the absence of the unusually high energy sales to drought-affected utilities recorded in 1977.

Average Annual Use Per Residential Customer



The average annual kilowatt-hour consumption of the Company's residential customers has remained level over the past five years which reflects, in part, the consistent manner in which SCE customers have been conserving energy.

Load Management Efforts Intensified

Load management, an important element of energy conservation, is the process of shifting electric use to off-peak periods which can improve the effective utilization of existing generating capacity and defer the need for some costly future plant expansion.

Time-of-use rates are designed to provide economic incentives to encourage customers to shift electric usage to non-peak periods on a voluntary basis. All large industrial customers on the Edison system are now on time-of-use rates, and tests are under way with other industrial, commercial and residential users.

The Company is engaged in pilot "Powershift" programs, involving more than 15,000 residential customers, in which air conditioners and electric water heaters are automatically cycled off and on for brief periods during hot days when electric demand on the Edison system is highest.

Other load management programs include thermal storage, swimming pool pump time-clock trippers, the promotion of solar energy units for supplemental water and space heating, increased installation of energy-efficient, high-pressure sodium vapor street lights, and co-generation projects with large customers.

Generating Resources Under Construction

The Company projects a need for more than 5,300 MW of new electric generating capacity to meet the estimated energy needs of its customers through 1988. About 50% of this addition will utilize nuclear fuel.

During 1978, Edison spent approximately $568 million on its construction program, and projects an expenditure of approximately $660 million for 1979.

Two combined cycle generating units at the existing Cool Water Generating Station were completed in 1978. The units together are rated initially at 360 MW.

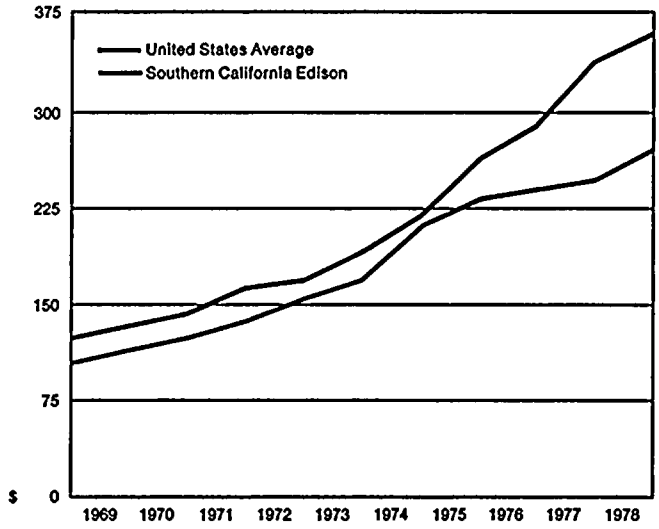
In addition, a 22-MW combustion turbine unit at the Axis Generating Station near Yuma, Arizona, began operation in December 1978.

The two 80% Edison-owned 1,100-MW units now under construction at the San Onofre Nuclear Generating Station site are more than 60% complete. The scheduled commercial operating dates are October 1981 for Unit No. 2, and January 1983 for Unit No. 3.

Construction of three units at the Palo Verde Nuclear Generating Station in western Arizona, in which Edison has a 15.8% interest, or 579 MW, is approximately 21% complete. The units are scheduled to begin operation in the 1982-86 period.

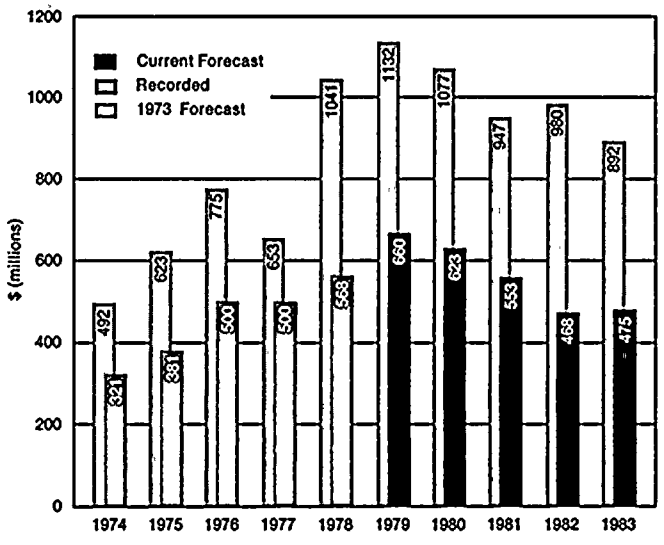
Construction also is under way on a 31-MW hydroelectric unit at Big Creek, scheduled for operation in 1980.

Average Annual Residential Bill



The average annual bill for the Company's residential customers compares favorably to the United States average.

Funds Required for Construction



Projections for kilowatt-hour consumption and peak demand have been reduced by nearly one-half from the pre-oil embargo growth rates of 7% projected in 1973 resulting in a reduced need for new capacity additions and substantially lower construction expenditures. Construction expenditures for the five-year period 1979 to 1983 currently are projected at approximately $2.8 billion.

Generating Resources Planned

Edison is participating in the planning studies and licensing efforts for two additional nuclear units at the Palo Verde Nuclear Generating Station for operation in 1988 and 1990, of which the Company's ownership interest would be 32.3%, or 789 MW.

Edison also is continuing its efforts to obtain necessary permits and approvals for construction of a 1,290-MW combined cycle generating station for the mid-1980s. Four alternate sites are under consideration. Because no practical alternative to this oil-fired plant could be built by the mid-1980s, when it is projected new capacity will be needed to meet customer demands, the Company plans to seek an exemption for this facility from the Federal Powerplant and Industrial Fuel Use Act of 1978 which contemplates that new power plants will burn primarily coal or coal-derived boiler fuels.

Construction of a 1,500-MW joint participation coal-fired electric generating station in the eastern California desert is being considered. Edison would be at least a 50% owner, and would serve as both project manager and operator. Subject to obtaining state and federal regulatory approvals in a timely manner, the proposed facility could be operational by the late 1980s.

New Energy Resources Pursued

Extensive efforts to develop energy alternatives to oil and natural gas were continued during the year, featuring pilot projects for coal gas, geothermal, solar and wind energy. While many of these resources are not expected to make a significant contribution to the energy supply until the end of the century, it is important that their potential be fully investigated and developed so they can be used economically at the earliest possible date.

A 100-MW coal gasification combined cycle plant is planned for the Cool Water site in an effort to demonstrate the feasibility of using a clean-burning coal gas to generate electrical power. The facility could be operational as early as 1983.

In the field of geothermal energy, Edison has formulated

Planned Capacity Additions
Ten-Year Period 1979-1988

Under Construction	No. Units	Fuel Type	Total Capacity (Megawatts)	Percent Complete 12-31-78	Scheduled Operation Date	% of Capacity Additions
Cool Water Combined Cycle Rerate[1]	2	Distillate Fuel Oil	108 MW	Not app.	1979	2.0
Long Beach 8 & 9 Rerate	2	Distillate Fuel Oil	53	Not app.	1979	1.0
Big Creek 3 #5	1	Hydro	31	12	1980	0.6
San Onofre 2 & 3	2	Nuclear	1760	63	1981, 1983	33.1
Palo Verde 1, 2 & 3	3	Nuclear	579	20	1982, 1984, 1986	10.9
Planned						
Fuel Cells	9	Distillate Fuel Oil	234		1983 - 1988	4.4
Balsam Meadow	1	Hydro	140		1985	2.6
Combined Cycle	3	Distillate Fuel Oil	1290		1985 - 1987	24.2
Geothermal[2]	4	Geothermal	108		1984 - 1987	2.0
Wind[3]	18	Wind	18		1986 - 1988	0.3
Combustion Turbine	2	Distillate Fuel Oil	110		1987	2.1
Coal[4]	2	Coal	500		1987 - 1988	9.4
Palo Verde 4	1	Nuclear	395		1988	7.4
			5326 MW			100.0%

[1] Total Project 468 MW; 360 MW placed in service during 1978.
[2] Includes two 9 MW demonstration units which are expected to become firm capacity following testing.
[3] Average capacity shown, based on 54 MW nameplate capacity at rated windspeed.
[4] Total project three 500 MW units, SCE share 750 MW.

agreements with two major resource development companies for geothermal resources for power plants at each of three major geothermal areas in the Imperial Valley of California. SCE's program includes technology development activities as well as the completion of a 9-MW plant by the end of 1979, and an additional 9-MW and a 45-MW plant by mid-1982.

Planning and engineering activities continued during the year on a joint 10-MW solar plant which will be the nation's first electric generating station powered directly by solar energy and connected to a utility grid. The facility, to be located at the Cool Water site, is scheduled for completion by the end of 1981. The project is a cooperative effort by Edison, the federal Department of Energy, the Los Angeles Department of Water and Power, and the California Energy Commission. Edison will serve as project manager for the non-solar portion of the plant.

Edison is constructing a test wind turbine generator (WTG) at its Devers Substation near Palm Springs. The unit is designed to produce 3 MW of electricity in a 40 mph wind, which makes it the highest output WTG under development in the nation. Test operation is scheduled to begin in mid-1979.

Positive Regulatory Actions Implemented

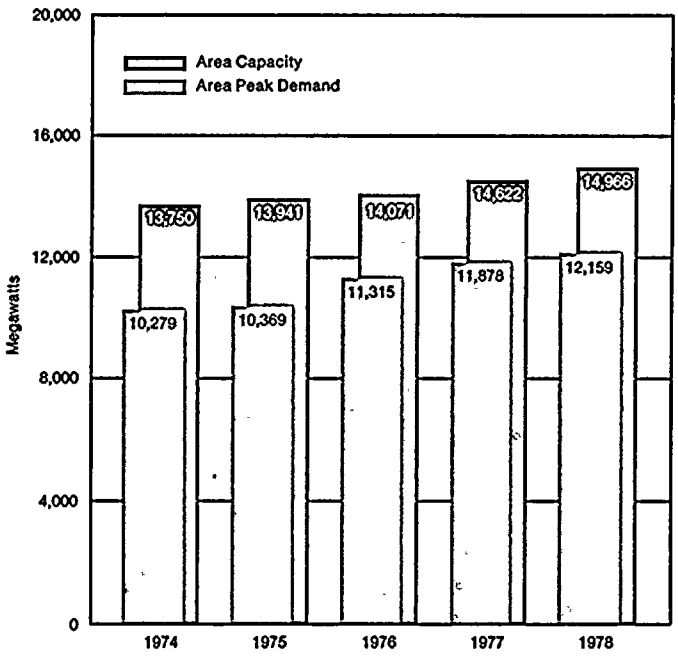
During the past several years, the California Public Utilities Commission (CPUC) has implemented some new and innovative ratemaking concepts addressing regulatory lag and energy cost recovery which, combined with the authorization of higher rates of return, have served progressively to improve the ratemaking climate within the state.

On December 12, the CPUC granted the Company an annual increase in general rates of $20 million, effective January 1, 1979, which, combined with the $104 million partial rate increase received in July, brought the total annual amount granted to $124 million based on a 1979 test year. Actions relating to the Tax Change Adjustment Clause (discussed below) are expected to provide an additional $34 million in annual revenues.

The final decision was issued only 14 months after filing under the CPUC's new plan to reduce regulatory lag. This is a significant improvement over the 30 months for Edison's prior general rate case.

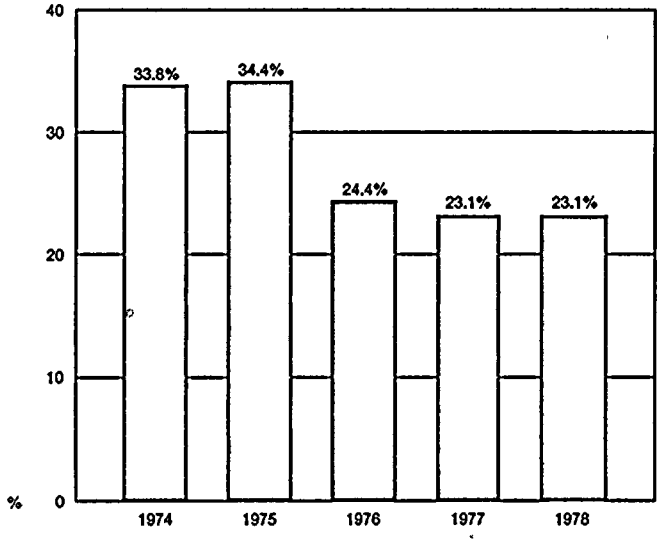
The decision authorized an increase in the rate of return component on common equity from 12.63% to 13.49% and raised the authorized rate of return on rate base from 8.8% to 9.6%. Also, in establishing the new rates, the CPUC adopted what the Company believes are more realistic levels of revenue and expense. These factors, combined with the fact that the new rates went into effect at the beginning of the 1979 test year, place Edison in a favorable position entering the new year.

Installed Area Capacity and Reserve Margin



A record area peak demand of 12,159 megawatts was recorded on September 25, 1978 during a period of extraordinary hot temperatures. The net main system peak reached 11,997 megawatts on the same day.

Installed Area Reserve Margin at Peak



Capacity under construction and current 23% reserve margin are sufficient to meet projected energy demands by SCE customers through 1984 while maintaining the Company's long-range reserve margin objective of approximately 18%.

The decision also called for a major revamping of the Company's tariff schedules as a means of encouraging conservation of electric energy. The CPUC recognizes that such conservation may reduce KWH sales and adversely impact earnings. In a separate investigation involving all major electric utilities which it regulates, the CPUC is exploring the development of an Adjustment Mechanism for Electric Sales, designed to help maintain authorized revenue levels when reduced sales result from customer conservation efforts.

Tax Change Adjustment Clause

California voters, in the June 1978 statewide election, approved Proposition 13, the property tax initiative which, among other things, limits taxation of real property.

Effective September 1, 1978, the CPUC authorized the Company's filing of a Tax Change Adjustment Clause (TCAC) designed to flow through to ratepayers the property tax savings experienced by the Company reduced by any offsetting changes in state or local government taxes, licenses, fees, or levies resulting from the passage of Proposition 13.

The rates established in the Company's recent general rate decision now reflect the lower post-Proposition 13 level of property taxes. However, the TCAC will remain in effect; thus, the Company's earnings should not be affected by any such tax changes experienced by the Company while the TCAC is in effect.

Resale Rates

On January 15, 1979, the Company filed with the Federal Energy Regulatory Commission (FERC) higher rates and an optional time-of-use rate for resale customers. The higher resale rates, requested to become effective March 16, are designed to increase annual revenues by approximately $5.5 million.

The Company is awaiting decisions from the FERC on two resale rate cases filed January 2, 1974, and October 31, 1975. They were designed to produce annual increases in resale revenues of approximately $12 million and $17 million, respectively. These revenues are being collected subject to refund.

Fuel Adjustment Clause Refund

During the year, the United States Supreme Court denied the Company's appeal of an earlier CPUC Order requiring the Company to refund revenues of approximately $133 million, plus interest on the unrefunded balance from May 1976. These revenues were collected under rates authorized by the CPUC through the Company's prior Fuel Adjustment Clause.

On December 12, the CPUC approved a plan for refunding the $133 million, plus approximately $45 million of interest, as reductions of customers' billings over a three-year period beginning January 1, 1979. The impact on earnings of the refund already has been reflected in the Company's financial statements for the years 1972-78, except for an estimated $18 million of the interest which is applicable to the three-year refund period.

Fuel Costs Remain High

Fuel costs continue to represent the Company's largest single item of expense, but the Energy Cost Adjustment Clause, instituted in 1976, is working well to relieve the impact of energy cost fluctuations on earnings.

Fuel and purchased power costs amounted to $1.2 billion in 1978, essentially the same as recorded for 1977. However, purchases from other utilities of low-cost power, generated primarily by hydroelectric and coal-fired units, as a substitute for expensive low-sulfur fuel oil, resulted in a savings of nearly $190 million in Edison's energy costs for 1978.

Low-sulfur fuel oil requirements for 1978 totaled 45 million barrels, down from the 58 million barrels consumed in 1977, a large portion of which was required for the production of electricity sold to other utilities more affected than Edison by the drought.

Costly Air Quality Rules Proposed

Stricter air quality regulations are being considered which, if implemented, could significantly increase the cost of electricity to customers.

The California Air Resources Board adopted a rule which requires a 50% reduction in emissions of oxides of nitrogen by 1982 with a further reduction to 90% by 1990 for electric utilities operating in the South Coast Air Basin of California. Capital costs for complying with this rule, which would be borne by electric customers, have been estimated at more than $1.1 billion over the life of the equipment.

The South Coast Air Quality Management District has proposed the adoption of a rule which would require SCE to lower the sulfur content of its fuel oil from 0.25% to 0.1%, or install sulfur oxide removal equipment on its plants to achieve the equivalent level of emissions by January 1, 1983. If such low-sulfur oil could be obtained, the increase in the Company's annual fuel cost is projected to range from $60 to $90 million with a commensurate effect on consumer rate levels.

SCE Signs Air Quality Pact

During the year, Edison signed an air pollution tradeoff agreement with Standard Oil of Ohio (SOHIO) calling for SOHIO to install and maintain a sulfur dioxide scrubber and nitrogen oxide reduction equipment at Edison's Alamitos Generating Station in Long Beach as a means of offsetting

a portion of the emissions from SOHIO's planned Long Beach harbor oil terminal.

The agreement, still subject to various regulatory approvals and certain tax rulings before it becomes operational, calls for SOHIO to pay approximately $28 million in capital costs for construction and an additional $50 million for operation and maintenance of the air pollution control equipment over a 15-year period.

Utilities Challenge Nuclear Laws

The constitutionality of the California nuclear laws which block development of nuclear power plants in the state was challenged in a suit filed October 2 by Edison and other interested California utilities.

The suit alleges the laws violate the Supremacy Clause of the U.S. Constitution because exclusive regulatory responsibility for the construction and operation of nuclear power plants lies with the federal Nuclear Regulatory Commission pursuant to federal law.

The California laws, passed in 1976, deal with the long-term storage of nuclear waste, reprocessing of nuclear fuel and construction of nuclear power plants.

Labor Dispute Resolved

A 12-week strike by approximately 1,100 workers at 10 of the Company's generating stations was concluded when the union voted to accept the Company's proposals. On July 26, Edison and Local 246 of the Utility Workers of America signed an agreement ending the longest work stoppage in Company history. The major issue of the labor dispute involved maintenance employees' work schedules. Personnel from various Company departments operated and maintained the electric generating stations during the strike period.

SCE Plans for Management Succession

The Company continues to plan for the continuity of effective management through formal programs of executive and manager development and replaceability. During the year, several management changes were made.

Philip L. Martin, previously Southeastern Division vice president, was elected vice president in charge of customer service, effective September 1.

Effective that same date, John R. Bury, previously assistant general counsel, became general counsel following the retirement of R. E. Woodbury, vice president and general counsel. Mr. Woodbury had served the Company with distinction for 38 years.

On May 1, Glenn J. Bjorklund was appointed Eastern Division vice president, succeeding Don M. Smith who retired after 41 years of valued service.

Employee Incentive Plan Implemented

As part of the Company's continuing objective to increase productivity and improve corporate effectiveness, an incentive productivity improvement plan was initiated effective January 1, 1979. The plan is designed to encourage employees to improve productivity. Awards of Edison common stock will be granted annually to employees on a competitive basis.

Affirmative Action Progress Continues

Progress in efforts to increase the representation of minorities and women throughout the work force was made during the year through the continued operation of SCE's Affirmative Action Program.

During 1978, minority representation increased from 18.9% at the beginning of the year to 20.7% at year-end. During the same period, female representation increased from 17.1% to 18.0%.

During the five-year period year-end 1973 through year-end 1978, minority representation in the work force increased from 14.9% to 20.7%, and the representation of women increased from 14.7% to 18.0%.

Percentage of Male, Female and Minority Employees at Year-End 1973 and 1978

	Male % Year-End		Female % Year-End		Black % Year-End		Asian American % Year-End		Native American Indian % Year-End		Hispanic % Year-End		Total Minorities % Year-End	
	1973	1978	1973	1978	1973	1978	1973	1978	1973	1978	1973	1978	1973	1978
Management[1]	94.5	91.4	5.5	8.6	1.6	2.1	2.7	3.8	0.4	0.6	3.3	5.5	8.2	11.9
Non-Management[2]	81.5	77.8	18.5	22.2	6.1	7.5	1.2	2.4	0.5	0.8	9.9	14.0	17.7	24.6
Total Company[3]	85.3	82.0	14.7	18.0	4.8	5.8	1.6	2.8	0.5	0.7	8.0	11.4	14.9	20.7

(1) Management employees include the "Officials and Managers," and "Professionals" Affirmative Action Categories.

(2) Non-Management employees include the "Technicians," "Office and Clerical," "Craftsmen," "Operators," "Laborers" and "Service Workers" Affirmative Action Categories

(3) Includes all classes of employees.

Financial Review

The following provides a review of the factors which the Company believes had a significant impact on earnings for the years 1977 and 1978. Reference also should be made to the accompanying financial statements and their related notes.

As discussed in Note 2 of the "Notes to Financial Statements," the Statements of Income have been restated to give retroactive effect to an April 27, 1976, decision of the CPUC relating to the Company's prior fuel adjustment clause.

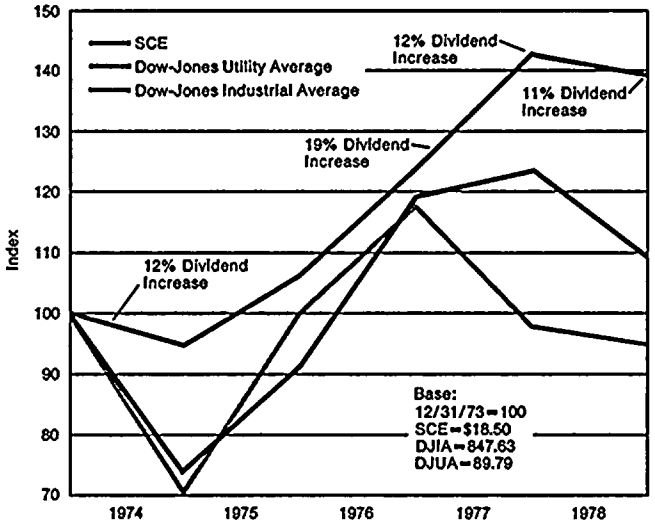
Summary

Although earnings for 1978 of $3.52 per share reflect a decline when compared with the $3.80 earned for both 1977 and 1976, it is encouraging to note that fourth quarter 1978 earnings improved in comparison with the corresponding quarter a year ago and reflected the first such increase since the first quarter of 1977. A review of recent earnings trends indicates that the $3.80 earned in 1976 occurred during the latter stages of an upswing in twelve-month-ended earnings per share which peaked in the first quarter of 1977. Restated earnings for the twelve-months-ended March 31, 1977, were $3.96 per share. On the other hand, the $3.80 per share earned for 1977 reflected a decline in earnings which continued until the third quarter of 1978 when twelve-months-ended earnings of $3.18 per share were reported. As noted above, however, earnings for the year 1978 recovered to $3.52 per share.

During the period under review, increases in the consumption of electricity by Edison customers have been modest, largely due to conservation activities. However, operating costs, affected adversely by inflation, have increased rapidly and unusually high maintenance expense, also similarly influenced by inflation, has been incurred.

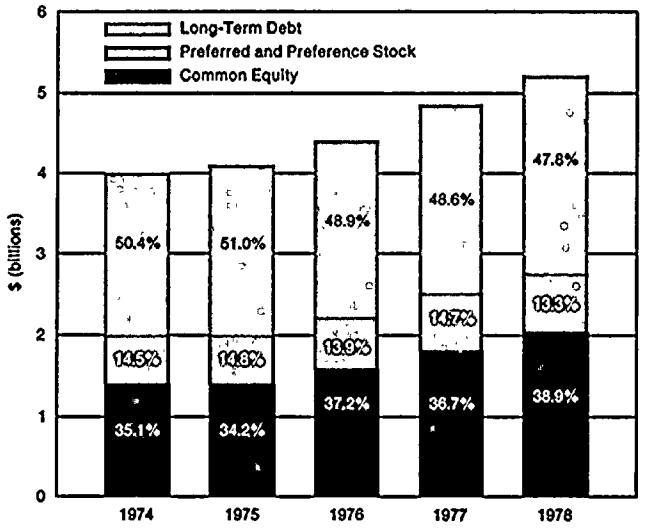
In addition, earnings were affected by continued higher money costs due to the on-going financing program and rising interest rates, and by the dilutive effect of equity financings, primarily issues of common stock — five million shares in December 1976 and six million shares in October 1978.

Stock Price Information



Since 1973, the price of the Company's common stock has increased 39% while the Dow Jones Utility Average increased 9% and the Dow Jones Industrial Average declined 5%.

Total Capitalization



At year-end 1978, the Company's capital structure was 47.8% Long-Term Debt, 13.3% Preferred and Preference Stock, and 38.9% Common Equity which is within SCE's capital structure objective.

Revenues

Because of the operation of the Company's Energy Cost Adjustment Clause (ECAC), including the balancing account feature, earnings are not affected by changes in fuel and purchased power costs; however, other unavoidable cost increases must be recovered through rate increases to the extent they cannot be recovered through increased productivity or through the modest growth the Company is experiencing in KWH consumption.

Although some rate relief was received in early 1977, it was not until the partial rate increase in July 1978, followed by the additional rate increase granted in the December final decision, that the cumulative effect of these increases could result in the Company earning a rate of return more nearly approximating the authorized level.

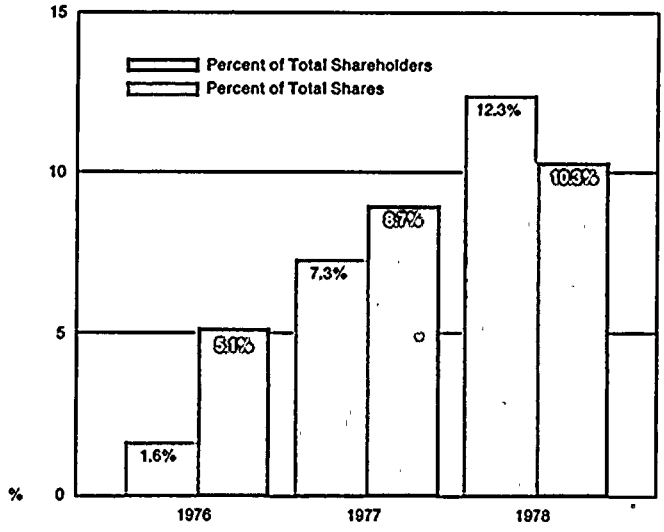
KWH consumption by Edison's customers, other than certain special contract customers, increased 3.6% in 1977 and 2.7% in 1978. Total KWH consumption rose by 7.5% in 1977, reflecting the high level of drought-related sales, but was down by 1.2% in 1978. Operating revenues increased by 11.8% and 12.8%, respectively, in 1977 and 1978, but after deduction of energy costs, the increases were 10.1% in 1977 and only 6.2% in 1978. However, since the partial rate increase was granted in July, this margin after energy costs has shown an increased trend — from an increase of 3.7% for the first three quarters to an increase of 14.1% for the fourth quarter.

Expenses

Increases in operation expenses, other than energy costs, of 8.2% in 1977 and 17.2% in 1978 were primarily due to the impact of inflation on costs of labor, materials and services and additional operating costs associated with system growth. Also, in 1978, expenses such as research and development, accruals for local franchise payments and the cost of funding the Company's pension program rose sharply.

Maintenance expenses increased by 17.7% and 23.2% in 1977 and 1978, respectively, over prior years. The increase in 1977 was largely the result of a greater number of generating units undergoing scheduled major periodic maintenance. Maintenance necessitated by severe storm damage in the first quarter was the primary cause for the increase in 1978. Barring unforeseen developments, maintenance expenses for 1979 should be significantly below the 1978 level.

Dividend Reinvestment and Stock Purchase Plan



At the end of 1978, more than 14,000 shareholders were participating in the Dividend Reinvestment and Stock Purchase Plan. During the year, participants purchased more than 600,000 shares with nearly $15.5 million of dividends and optional cash payments.

1978 Financings

Month	Issue	Net Proceeds (Millions)
October	Common Stock — 6,000,000 shares	$148
November	25-year 9¾% First & Refunding Mortgage Bonds Annual Cost — 9.78%	197
Periodically	Dividend Reinvestment and Stock Purchase Plan, Employee Stock Purchase Plan, and the Tax Reduction Act Employee Stock Ownership Plan	37
		$382

Financing Program Continues

Two large, publicly-offered issues of securities were sold during 1978, which raised approximately $345 million in new capital to help finance the Company's continuing construction program.

On October 25, the Company issued six million shares of common stock at a market price of $25⅜ per share.

On November 9, the Company completed the sale of $200 million of 25-year First and Refunding Mortgage Bonds, Series JJ. The issue was sold at a cost of money to the Company of 9.78%.

In addition, approximately $37 million was raised through the sale of common stock under the Company's Employee Stock Purchase Plan (ESPP), the Dividend Reinvestment and Stock Purchase Plan (DRP), and the Tax Reduction Act Stock Ownership Plan (TRASOP), which brought the Company's total financings for the year to $382 million.

Current financing plans for 1979 call for the issuance of approximately $300 million in mortgage bonds and preferred stock. No offering of common stock is anticipated except for shares issued under ESPP, DRP and TRASOP.

Stock Plan Shows Growth

At the end of 1978, more than 14,000 shareholders, or about 10% of the holders of the Company's common stock, were participating in the DRP. During the year, participants purchased more than 600,000 shares with nearly $15.5 million of dividends and optional cash payments. Since the plan was started in 1976, $25 million has been invested in new shares.

Operating Revenues and Kilowatt-Hour Consumption

Class of Service	*Operating Revenues (000)*				*Kilowatt-Hour Consumption (000)*			
	% of 1978 total	*1978*	*1977*	*% change*	*% of 1978 total*	*1978*	*1977*	*% change*
Residential	30.2	$ 704,658	$ 616,520	14.3	27.0	15,369,184	14,285,971	7.6
Agricultural	1.7	40,449	50,781	(20.3)	1.5	851,017	1,377,939	(38.2)
Commercial	26.2	610,735	505,469	20.8	24.4	13,937,000	13,388,075	4.1
Industrial	25.5	593,580	481,587	23.3	29.2	16,652,243	16,393,105	1.6
Public Authorities-Other	8.7	202,573	173,018	17.1	8.2	4,656,895	4,646,504	0.2
Interdepartmental	—	30	22	36.4	—	1,015	731	38.9
Resale-Other	5.8	134,038	129,785	3.3	7.3	4,170,027	4,061,526	2.7
Subtotal	98.1	2,286,063	1,957,182	16.8	97.6	55,637,381	54,153,851	2.7
Resale-Special Contracts	0.2	4,215	78,360	(94.6)	0.4	233,106	2,552,753	(90.9)
Public Authorities-Special	0.2	4,265	15,036	(71.6)	2.0	1,156,548	1,019,669	13.4
Total Sales of Electric Energy	98.5	2,294,543	2,050,578	11.9	100.0	57,027,035	57,726,273	(1.2)
Other Electric Revenues	1.5	34,255	14,336	138.9	—	—	—	—
Total	100.0	$2,328,798	$2,064,914	12.8	100.0	57,027,035	57,726,273	(1.2)

Report of Management

The accompanying financial statements have been prepared by Company personnel in conformity with generally accepted accounting principles appropriate in the circumstances applied on a consistent basis. The integrity and objectivity of the data in these financial statements are the responsibility of management. In order to assure such integrity and objectivity, the Company maintains a highly developed system of internal controls. This system includes communication by written policies and procedures, organization structures that provide for appropriate division of responsibility, and the selection and training of qualified personnel and is augmented by programs of internal audits.

An independent examination of these financial statements has been conducted by Arthur Andersen & Co., independent public accountants, in accordance with generally accepted auditing standards. The accompanying Report of the Independent Public Accountants expresses an informed opinion as to whether the financial statements, considered in their entirety, present fairly the Company's financial position, results of operations and changes in financial position, in conformity with generally accepted accounting principles applied on a consistent basis.

The Board of Directors has established an Audit Committee which in their opinion is entirely composed of Directors who are free from any relationships that would interfere with the exercise of independent judgment as Audit Committee members. The Audit Committee meets periodically with management, the independent public accountants and the internal auditors to make inquiries as to the manner in which the responsibilities of each are being discharged and reports thereon to the Board of Directors. In addition, the Audit Committee recommends to the Board of Directors the annual appointment of the independent public accountants with whom the Audit Committee reviews the scope of the audit and non-audit assignments, the accounting principles being applied by the Company in financial reporting and the adequacy of internal controls and internal audit procedures.

To further assure independence in performing and reporting the results of audits, representatives of the independent public accountants and the Company's staff of internal auditors have full and free access to meet with the Audit Committee, without members of Company management being present, to discuss any accounting, auditing, or financial reporting matter.

H. Fred Christie
Senior Vice President and Chief Financial Officer

Jack K. Horton
Chairman of the Board and Chief Executive Officer

Report of Independent Public Accountants

To the Shareholders and the Board of Directors,
Southern California Edison Company:

We have examined the balance sheets and statements of capital stock and long-term debt of Southern California Edison Company (a California corporation, hereinafter referred to as the "Company"), as of December 31, 1978 and 1977, and the related statements of income, earnings reinvested in the business, additional paid-in capital and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our report dated February 8, 1978, our opinion on the balance sheet as of December 31, 1977 was qualified subject to the effect of adjustments, if any, that might result from an April 27, 1976 decision of the California Public Utilities Commission. As discussed in Note 2 of "Notes to Financial Statements", this decision was affirmed on March 23, 1978 by the California Supreme Court. The financial statements have been revised to give retroactive effect to the decision. Accordingly, our present opinion on the balance sheet as of December 31, 1977, as revised, is no longer qualified.

In our opinion, the financial statements referred to above present fairly the financial position of the Company as of December 31, 1978 and 1977, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied during the periods.

Los Angeles, California
February 9, 1979

ARTHUR ANDERSEN & CO.

Southern California Edison Company

Statements of Income

		Year Ended December 31, 1978	1977
		Thousands of Dollars	
Operating Revenues:	Sales *(Notes 1, 2 and 4)*	$2,294,543	$2,050,57
	Other	34,255	14,336
	Total operating revenues *(Note 3)*	2,328,798	2,064,914
Operating Expenses:	Fuel *(Note 4)*	1,086,051	1,113,028
	Purchased power	118,698	76,569
	Provision for energy cost adjustments *(Note 1)*	35,280	(149,506)
	Subtotal — energy costs	1,240,029	1,040,091
	Other operation expenses *(Notes 4, 6 and 7)*	283,622	241,963
	Maintenance *(Note 1)*	164,111	133,166
	Provision for depreciation *(Note 1)*	157,203	140,520
	Taxes on income — current and deferred *(Notes 1, 2 and 5)*	72,803	68,792
	Property and other taxes	86,429	109,660
	Total operating expenses	2,004,197	1,734,192
Operating Income *(Note 3)*		324,601	330,722
Other Income and Income Deductions:	Allowance for equity funds used during construction *(Note 1)*	58,471	46,23
	Other — net *(Notes 5 and 10)*	31,319	22,09
	Total other income and income deductions	89,790	68,330
Total Income before Interest Charges		414,391	399,052
Interest Charges:	Interest on long-term debt	154,301	143,152
	Other interest and amortization *(Notes 1 and 2)*	28,357	17,926
	Total interest charges	182,658	161,078
	Allowance for debt funds used during construction *(Note 1)*	(19,950)	(14,005)
	Net interest charges	162,708	147,073
Net Income *(Note 3)*		251,683	251,979
Dividends on Cumulative Preferred and Preference Stock		49,457	45,649
Earnings Available for Common and Original Preferred Stock *(Note 2)*		$ 202,226	$ 206,330
Weighted Average Shares of Common and Original Preferred Stock Outstanding and Common Stock Equivalents (000)		57,477	54,347
Earnings Per Share *(Notes 2, 3 and 9)*:	Primary	$3.52	$3.80
	Fully diluted	$3.38	$3.63

The accompanying notes are an integral part of these statements.

Southern California Edison Company

Statements of Changes in Financial Position

		Year Ended December 31, 1978	1977
		Thousands of Dollars	
Funds Provided By:			
Operations —	Net income	$251,683	$251,979
	Non-fund items —		
	Depreciation	157,203	140,520
	Equity in earnings of unconsolidated subsidiaries *(Note 1)*	(608)	(551)
	Allowance for debt and equity funds used during construction *(Note 1)*	(78,421)	(60,238)
	Investment tax credit deferred — net *(Notes 1 and 5)*	32,568	26,886
	Other — net	4,788	8,152
	Customer refunds — net *(Note 2)*	36,918	4,774
	Earnings distributed from unconsolidated subsidiaries	1,000	1,000
	Total from operations	405,131	372,522
Long-term financing —	Preferred stock	—	60,000
	Preference stock*	(14,522)	42,419
	Common stock*	203,364	43,323
	Long-term debt	200,000	200,000
	Total from long-term financing	388,842	345,742
Other sources —	Construction advances and other	9,258	9,102
	Sale of non-current assets	—	10,883
	Decrease in working capital	13,067	—
	Total from other sources	22,325	19,985
	Total funds provided	$816,298	$738,249
Funds Applied To:	Construction additions — net	$646,252	$560,507
	Less — allowance for debt and equity funds used during construction *(Note 1)*	78,421	60,238
	Funds used for construction expenditures	567,831	500,269
	Advances to unconsolidated subsidiaries	3,630	(999)
	Dividends	182,738	157,561
	Repayment of long-term debt	35,500	—
	Other — net	26,599	2,015
	Increase in working capital	—	79,403
	Total funds applied	$816,298	$738,249
Working Capital Changes (Other than current maturities of long-term debt):	Receivables and temporary cash investments	$ 79,155	$ 86,554
	Fuel stock, materials and supplies	(114,118)	84,672
	Deferred energy costs — net *(Note 1)*	(14,286)	72,849
	Notes and accounts payable	68,803	(145,639)
	Taxes, interest accrued and other	(32,621)	(19,033)
	Increase (Decrease) in working capital	$ (13,067)	$ 79,403

*These amounts reflect conversions of Preference Stock, 5.20% Convertible Series, to Common Stock in the amounts of $14,522,000 and $19,581,000, respectively.

The accompanying notes are an integral part of these statements.

Southern California Edison Company

Balance Sheets

ASSETS

		December 31, 1978	December 31, 1977
		Thousands of Dollars	
Utility Plant:	Utility plant, at original cost less contributions *(Notes 1 and 4)*	$5,303,746	$4,964,888
	Less — Accumulated provision for depreciation *(Note 1)*	1,519,174	1,383,009
	Net utility plant	3,784,572	3,581,879
	Construction work in progress *(Note 6)*	1,493,573	1,209,502
	Nuclear fuel, at amortized cost	13,572	17,343
	Total utility plant	5,291,717	4,808,724
Other Property and Investments:	Real estate and other, at cost — less accumulated provision for depreciation	7,658	6,024
	Subsidiary companies *(Notes 1 and 10)*	85,818	82,579
	Total other property and investments	93,476	88,603
Current Assets:	Cash *(Note 4)*	7,458	9,245
	Temporary cash investments	80,532	—
	Receivables, less reserves of $5,608,000 and $5,714,000 for uncollectible accounts at respective dates *(Notes 1 and 8)*	211,625	213,002
	Fuel stock, at cost *(first-in, first-out)*	163,021	277,586
	Materials and supplies, at average cost	28,463	28,016
	Deferred energy costs *(Notes 1 and 5)*	102,369	132,559
	Prepayments and other (taxes, insurance, etc.)	42,022	63,476
	Total current assets	635,490	723,884
Deferred Debits:	Unamortized debt expense *(Note 1)*	14,709	14,110
	Accumulated deferred income taxes — customer refunds *(Notes 2 and 5)*	—	78,801
	Other deferred charges	22,305	11,144
	Total deferred debits	37,014	104,055
		$6,057,697	$5,725,266

The accompanying notes are an integral part of these balance sheets.

CAPITALIZATION AND LIABILITIES		December 31, 1978	1977
		Thousands of Dollars	
Shareholders' Equity:	Original preferred stock	$ 4,000	$ 4,000
	Cumulative preferred stock	593,755	593,755
	Preference stock	102,895	117,417
	Common stock, including additional stated capital	547,166	470,374
	Total capital stock — stated value	1,247,816	1,185,546
	Additional paid-in capital	569,673	443,109
	Earnings reinvested in the business *(Note 2)*	931,217	862,956
	Total shareholders' equity	2,748,706	2,491,611
Long-Term Debt *(Notes 1 and 8)*		2,477,474	2,314,874
	Total capitalization	5,226,180	4,806,485
Current Liabilities:	Accounts payable	154,495	169,128
	Commercial paper payable *(Note 4)*	—	135,365
	Notes payable to banks *(Note 4)*	19,986	—
	Current maturities of long-term debt	33,737	35,500
	Customer refunds — current *(Note 2)*	52,724	—
	Taxes accrued *(Note 5)*	92,550	95,753
	Interest accrued	51,069	47,802
	Customer deposits	15,601	14,267
	Dividends declared	43,205	35,223
	Accumulated deferred income taxes — deferred energy costs *(Notes 1 and 5)*	53,928	69,832
	Other	23,612	15,127
	Total current liabilities	540,907	617,997
Commitments and Contingencies *(Note 4)*			
Reserves and Deferred Credits:	Customer advances and other deferred credits	46,115	40,804
	Customer refunds *(Note 2)*	107,774	149,657
	Accumulated deferred income taxes and investment tax credits *(Notes 1 and 5)*	110,096	80,870
	Reserves for pensions, insurance, etc. *(Note 7)*	26,625	29,453
	Total reserves and deferred credits	290,610	300,784
		$6,057,697	$5,725,266

The accompanying notes are an integral part of these balance sheets.

Statements of Earnings Reinvested in the Business

		Year Ended December 31, 1978	1977
		Thousands of Dollars	
Balance at January 1	As previously reported	$ 862,956	$ 835,507
	Adjustments *(Note 2)*	—	(66,082)
	As restated	862,956	769,425
Add:	Net income	251,683	251,979
	Transfer of amortization reserve — Federal (a)	3,801	—
		1,118,440	1,021,404
Deduct:	Dividends declared on capital stock —		
	Original preferred	1,075	922
	Cumulative preferred	42,532	38,423
	Preference	6,926	6,844
	Common — $2.30 per share for 1978 and $2.06 per share for 1977	132,205	111,372
	Capital stock expense	4,485	887
		187,223	158,448
Balance at December 31		$ 931,217	$ 862,956

(a) Pursuant to a regulatory order, an operating reserve relating to certain federally-licensed hydroelectric projects was transferred to Earnings Reinvested in the Business and became an appropriation thereof.

Statements of Additional Paid-in Capital

	Year ended December 31, 1978	1977
	Thousands of Dollars	
Balance at January 1	$443,109	$427,422
Premium received on sale of common stock	126,572	15,690
Payments made in lieu of issuing fractional shares of common stock	(8)	(3)
Balance at December 31	$569,673	$443,109

The accompanying notes are an integral part of these statements.

Southern California Edison Company

Statements of Capital Stock

	December 31, 1978		December 31,	
	Shares Outstanding	Redemption Price Per Share	1978	1977
			Thousands of Dollars	
Original Preferred — 5%, prior, cumulative, participating, not redeemable, authorized 480,000 shares, par value $8⅓ per share	480,000		$ 4,000	$ 4,000
Cumulative Preferred — authorized 24,000,000 shares, par value $25 per share (a)				
4.08% Series	1,000,000	$ 25.50	25,000	25,000
4.24% Series	1,200,000	25.80	30,000	30,000
4.32% Series	1,653,429	28.75	41,336	41,336
4.78% Series	1,296,769	25.80	32,419	32,419
5.80% Series	2,200,000	25.65	55,000	55,000
8.85% Series	2,000,000	27.20	50,000	50,000
9.20% Series	2,000,000	27.25	50,000	50,000
$100 Cumulative Preferred — authorized 6,000,000 shares, par value $100 per share (a) (c)				
7.325% Series	750,000	110.00	75,000	75,000
7.58% Series	750,000	105.00	75,000	75,000
7.80% Series	600,000	110.00	60,000	60,000
8.70% Series	500,000	111.00	50,000	50,000
8.96% Series	500,000	111.00	50,000	50,000
			593,755	593,755
Preference — authorized 10,000,000 shares, par value $25 per share (a) (b) (c)				
5.20% Convertible Series	1,635,820	25.00	40,895	55,417
7.375% Series	2,480,000	26.25	62,000	62,000
			102,895	117,417
Common — authorized 90,000,000 shares, par value $8⅓ per share, including additional stated capital (b) (c)	62,536,581		547,166	470,374
Total capital stock — stated value (d)			$1,247,816	$1,185,546

(a) All series of $100 Cumulative Preferred Stock, Cumulative Preferred Stock and Preference Stock are redeemable at the option of the Company. The various series of $100 Cumulative Preferred Stock, the Cumulative Preferred Stock, 8.85% Series and 9.20% Series, and the Preference Stock, 7.375% Series, are subject to certain restrictions on redemption for refunding purposes. The $100 Cumulative Preferred Stock, 7.325% Series, has a cumulative sinking fund provision requiring the redemption of 30,000 shares annually at $100 per share plus accumulated unpaid dividends, commencing July 31, 1983, and continuing until all shares are redeemed. Commencing September 1, 1984, and continuing until all shares are repurchased, the Company has a contractual obligation to purchase a minimum of 496,000 shares annually of its Preference Stock, 7.375% Series, at $25 per share plus accumulated unpaid dividends. Commencing November 30, 1983, and continuing until all shares are redeemed, the $100 Cumulative Preferred Stock, 7.80% Series, has a cumulative sinking fund provision requiring the annual redemption of a specified percentage of the shares originally outstanding (2.5% in 1983 and increasing to 5.5% by 2003) at $100 per share plus accumulated unpaid dividends.

(b) Under a prescribed formula, the conversion prices of convertible securities are adjusted when additional shares of Common Stock are sold by the Company. On December 31, 1978, the shares of Common Stock reserved for the conversion of the Preference Stock, 5.20% Convertible Series, amounted to 1,202,809 shares at the adjusted conversion price of $34.00 per share. In addition, 1,997,388 shares of Common Stock were reserved for the conversion of 3⅛% Convertible Debentures, due 1980, at the adjusted conversion price of $37.50 per share.

(c) Transactions in the capital stock accounts during 1977 and 1978 reflect the following: In 1977, 2,480,000 shares of Preference Stock, 7.375% Series, were issued; 600,000 shares of $100 Cumulative Preferred Stock, 7.80% Series, were issued; 783,226 shares of Preference Stock, 5.20% Convertible Series, were converted into 551,452 shares of Common Stock; and 540,081, 323,932 and 102,262 shares of Common Stock were issued under the Company's Employee Stock Purchase Plan, Dividend Reinvestment and Stock Purchase Plan, and Tax Reduction Act Employee Stock Ownership Plan, respectively. During 1978, 631,521, 637,014, and 203,879 shares of Common Stock were issued under the Company's Employee Stock Purchase Plan, Dividend Reinvestment and Stock Purchase Plan, and Tax Reduction Act Employee Stock Ownership Plan, respectively; 580,854 shares of Preference Stock, 5.20% Convertible Series, were converted into 417,710 shares of Common Stock; and on October 25, 1978, 6,000,000 shares of Common Stock were issued at an initial public offering price of $25.375 per share.

(d) The Company's Articles of Incorporation authorize the issuance of 2,000,000 shares of $100 Preference Stock, $100 par value, none of which was outstanding as of December 31, 1978 and 1977.

The accompanying notes are an integral part of these statements.

Southern California Edison Company

Statements of Long-term Debt

			December 31, 1978	December 31, 1977
			Thousands of Dollars	
First and Refunding Mortgage Bonds (a):	Series E,	Due 1978 (3⅝%)	$ —	$ 30,000
	Series F,	Due 1979 (3%)	30,000	30,000
	Series G,	Due 1981 (3⅝%)	40,000	40,000
	Series H,	Due 1982 (4¼%)	37,500	37,500
	Series I,	Due 1982 (4¾%)	40,000	40,000
	Series J,	Due 1982 (4⅞%)	40,000	40,000
	Series K,	Due 1983 (4⅝%)	50,000	50,000
	Series L,	Due 1985 (5%)	30,000	30,000
	Series M,	Due 1985 (4⅜%)	60,000	60,000
	Series N,	Due 1986 (4½%)	30,000	30,000
	Series O,	Due 1987 (4¼%)	40,000	40,000
	Series P,	Due 1987 (4¼%)	50,000	50,000
	Series Q,	Due 1988 (4⅜%)	60,000	60,000
	Series R,	Due 1989 (4⅜%)	60,000	60,000
	Series S,	Due 1990 (4½%)	60,000	60,000
	Series T,	Due 1991 (5¼%)	75,000	75,000
	Series U,	Due 1991 (6⅛%)	80,000	80,000
	Series V,	Due 1992 (5⅞%)	80,000	80,000
	Series W,	Due 1993 (6⅜%)	100,000	100,000
	Series X,	Due 1994 (7⅛%)	75,000	75,000
	Series Y,	Due 1994 (8⅛%)	100,000	100,000
	Series Z,	Due 1995 (7⅞%)	100,000	100,000
	Series AA,	Due 1996 (8%)	100,000	100,000
	Series BB,	Due 1997 (7⅜%)	125,000	125,000
	Series CC,	Due 1999 (8¼%)	100,000	100,000
	Series DDP,	Due 1999 (7%)	15,030	15,030
	Series EE,	Due 1981 (9%)	100,000	100,000
	Series FF,	Due 2000 (8⅞%)	150,000	150,000
	Series GG,	Due 2001 (8⅞%)	125,000	125,000
	Series HH,	Due 2002 (8¼%)	125,000	125,000
	Series II,	Due 1984 (7¼%)	75,000	75,000
	Series JJ,	Due 2003 (9⅝%)	200,000	—
			2,352,530	2,182,530
First Mortgage Bonds (Calectric) (a)		Due 1978-1991 (2⅞%-5⅛%)	66,000	71,500
Convertible Debentures (b)		Due 1980 (3⅛%)	74,902	74,902
Promissory Notes *(Note 8)*		Due 1979-1983 (5½%)	17,953	17,953
Principal amounts outstanding			2,511,385	2,346,885
Current maturities of long-term debt (c)			(33,737)	(35,500)
Unamortized premium or (discount) — net			(174)	3,489
Total long-term debt			$2,477,474	$2,314,874

(a) All mortgage bonds are secured by utility plant, substantially all of which is subject to a lien under the trust indentures. Additional First and Refunding Mortgage Bonds may be issued subject to the provisions of the applicable trust indentures. Each of the bond indentures requires special deposits with the trustees, which are based primarily upon the amount of bonds outstanding. These deposit requirements of $68,280,067 in 1978 were satisfied by property additions and replacements. The Company expects to satisfy these requirements in the same manner in 1979. The First and Refunding Mortgage Bonds, Series DDP, are subject to a mandatory sinking fund commencing on July 1, 1990.

(b) At December 31, 1978 and 1977, the 3⅛% Convertible Debentures, Due 1980, were convertible at the adjusted rate of one share of Common Stock for each $37.50 and $39.00, respectively, of the principal amount of such debentures. Any such debentures which are converted may not be reissued.

(c) Current maturities of long-term debt at December 31, 1978, included $3,737,000 principal amount of 5½% Promissory Notes and $30,000,000 principal amount of First and Refunding Mortgage Bonds, Series F, Due August 15, 1979. The amounts of maturing long-term debt will be: $84,544,000 in 1980; $143,548,000 in 1981; $121,025,000 in 1982; and $53,501,000 in 1983.

The accompanying notes are an integral part of these statements.

Notes to Financial Statements

Note 1 — Summary of Significant Accounting Policies

The Company is a public utility primarily engaged in the business of supplying electric energy in portions of central and southern California, excluding the City of Los Angeles and certain other cities. The accounting records of the Company are maintained in accordance with the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission ("FERC") and adopted by the California Public Utilities Commission ("CPUC").

Additions to utility plant and replacements of retirement units of property are capitalized at original cost less contributions, which cost includes labor, material, indirect charges for engineering, supervision, transportation, etc., and an allowance for debt and equity funds used during construction. Maintenance is charged with the cost of repairs and minor renewals; plant accounts with the replacement of property units; and the depreciation reserve with the cost, less net salvage, of property units retired. The Company owns undivided interests in certain jointly-owned facilities and the balance sheet at December 31, 1978 includes utility plant, accumulated provision for depreciation, and construction work in progress of $510,127,000, $108,856,000, and $1,316,919,000, respectively, for such facilities.

Allowance for funds used during construction ("ADC") is the generally accepted utility accounting procedure designed to capitalize the cost of both debt and equity funds used to finance plant additions during construction periods and to restore net income to the level which would have been experienced without a construction program through a transfer of such costs from the income statement to the balance sheet as utility plant construction work in progress. Such costs are recovered from ratepayers as a cost of service through provisions for depreciation in future periods. Although ADC increases net income, it does not represent current cash earnings.

Depreciation of utility plant is computed on a straight-line remaining life basis for financial statement purposes and approximated 3.2% and 3.1% of average depreciable plant for the years 1978 and 1977, respectively. Although the eventual cost of retiring a nuclear generating unit cannot be predicted with certainty, the Company has estimated that decommissioning costs will approximate $36,000,000 for nuclear generation facilities in service. The Company's rates are designed to recover such costs through depreciation expense over the estimated remaining useful lives of such facilities. Current income tax expense has been reduced by the current tax reductions arising from the use of liberalized methods and lives in computing depreciation for income tax purposes and a portion of investment tax credits ("ITC"). The current reduction of income tax liability due to certain additional ITC made available by the Tax Reduction Act of 1975 and the Tax Reform Act of 1976 is being normalized.

Debt premium or discount and related expenses are being amortized to income over the lives of the issues to which they pertain.

Customers are billed monthly, except for most residential customers who are billed bi-monthly. Revenues are recorded when customers are billed.

Deferred energy costs result from the Company's Energy Cost Adjustment Clause ("ECAC"), which requires monthly entries to adjust the results of operations and maintenance of a balancing account for overcollections or undercollections. Variations between ECAC revenues and the related energy costs included in rates are deferred until such variations are refunded to, or recovered from, utility customers through CPUC authorized rate adjustments. ECAC related energy costs include incurred transportation and storage costs related to spent nuclear fuel. The income tax effects of ECAC also are deferred. For income tax purposes, billed revenues and incurred energy costs are utilized in the determination of taxable income.

Investments in unconsolidated subsidiary companies, all of which are wholly owned, are accounted for under the equity method of accounting.

Note 2 — Prior Period Adjustments

The amounts of earnings available for Common and Original Preferred Stock for the years 1972-1977, inclusive, have been revised from the amounts previously reported to give retroactive effect to an April 27, 1976 decision of the CPUC which was affirmed by the California Supreme Court on March 23, 1978. On October 16, 1978, the United States Supreme Court denied the Company's appeal of this decision. The combined effect of the CPUC decision and a CPUC order issued December 12, 1978, requires the Company to refund, as reductions of customers' billings over a three-year period which began January 1, 1979, revenues collected pursuant to the operation of the Company's fuel adjustment clause during the period May 1972 through April 1976, in the approximate amount of $133,000,000 and approximately $45,000,000 of interest for the period from May 1976 through December 1981. Except for an estimated $18,000,000 of the interest which is applicable to and will be recorded during the three-year refund period, the earnings impact of the refund has been reflected in the Company's financial statements for periods ending prior to January 1, 1979. For previously reported annual periods, these retroactive adjustments reduced earnings available for Common and Original Preferred Stock and primary earnings per share by $1,702,000 ($0.04 per share) for 1972, $1,621,000 ($0.03 per share) for 1973, $57,954,000 ($1.30 per share) for 1974, and $9,881,000 ($0.21 per share) for 1975; whereas the

adjustments increased such items for 1976 by $5,076,000 ($0.10 per share) because of undercollections, and reduced such items by $4,774,000 ($0.08 per share) for 1977, as follows:

	Thousands of Dollars				
	Earnings as Reported	Increase or (Decrease) of Earnings			Earnings as Adjusted
Year		Operating Revenues	Interest Charges	Taxes on Income	
1972	$112,171	$ (3,542)	$ —	$ 1,840	$110,469
1973	118,889	(3,399)	—	1,778	117,268
1974	182,610	(122,473)	—	64,519	124,656
1975	147,058	(20,881)	—	11,000	137,177
1976	179,971	17,072	(6,345)	(5,651)	185,047
1977	211,104	—	(10,089)	5,315	206,330
		$(133,223)	$ (16,434)	$78,801	

Note 3 — Quarterly Financial Data (Audited)

	Thousands of Dollars			Earnings Per Share	
Three Months Ended	Operating Revenues	Operating Income	Net Income	Primary	Fully Diluted
December 31, 1978 ...	$600,902	$99,162	$85,455	$1.19	$1.15
September 30, 1978 ...	634,934	90,778	68,846	1.00	0.96
June 30, 1978	545,444	70,612	50,912	0.69	0.67
March 31, 1978	547,518	64,050	46,470	0.62	0.59
December 31, 1977* ..	536,446	80,040	59,987	0.88	0.84
September 30, 1977* ..	550,790	87,681	67,604	1.03	0.99
June 30, 1977*	471,859	76,999	56,790	0.84	0.80
March 31, 1977*	505,819	86,002	67,598	1.05	1.00

**Restated as explained in Note 2.*

Note 4 — Commitments and Contingencies

Construction program and fuel supply —
The Company has significant purchase commitments in connection with its continuing construction program. Funds required for construction expenditures are estimated at $660,000,000 for 1979. In addition, minimum long-term commitments of approximately $6.6 billion existed on December 31, 1978 under the Company's fuel supply and transportation arrangements.

Government licenses —
Major hydroelectric plants together with certain reservoirs are located in whole or in part on lands of the United States under Government licenses and permits which expire between 1979 and 2009. Such licenses and permits contain numerous restrictions and obligations, including the right of the United States to acquire the projects, under certain conditions, upon payment of specified compensation.

Revenues —
Pursuant to FERC procedures, on May 2, 1974, August 4, 1974 and February 1, 1976, rate increases applicable to resale sales became effective, subject to refund with interest to the extent that any of the increases are subsequently determined by the FERC to be inappropriate. For the period May 2, 1974 through December 31, 1978, additional revenues of approximately $272,000,000 billed under these rate filings remain subject to refund. A FERC decision dated April 26, 1978, determined that substantially all of the increased rates relating to a fuel cost adjustment clause placed in effect on May 2, 1974 were just and reasonable. In August 1978, certain of the Company's resale customers filed a petition with the U.S. Court of Appeals, District of Columbia Circuit, for a review of this decision. If the Court of Appeals sustains the FERC decision, approximately $225,000,000 of such additional revenues billed during the period from August 4, 1974 through December 31, 1978, will remain subject to refund. The Company believes that based on these and other facts, the amount of revenues, if any, which may be required to be refunded would not have a significant effect on net income in any of the related periods.

Leases and rentals —
The Company has entered into various arrangements to lease nuclear fuel, automotive equipment, computer equipment, office space and other incidental equipment and property which are accounted for as operating leases. Neither the annual gross lease expense nor the present value of the minimum commitments of capital leases are material.

Compensating balances and short-term debt —
In order to continue lines of credit with various banks, which amounted to approximately $170,000,000 on December 31, 1978 and $161,000,000 on December 31, 1977, the Company presently maintains deposits aggregating approximately $14,000,000 which are not legally restricted as to withdrawal. None of such lines of credit was used during 1978 and 1977. The variation between cash reported on the Company's balance sheet and the minimum aggregate deposits recorded by the banks is "float," which is due to timing differences in recording deposits and withdrawals by the Company and the banks.

The Company has an additional $150,000,000 line of credit which may be utilized only for the purchase of fuel oil through the use of bankers' acceptances. Notes issued under this arrangement are secured by a pledge of the Company's fuel oil inventory.

The maximum amount of bankers' acceptances outstanding for 1978 and 1977 was $68,545,000 and $72,006,000,

respectively. The average daily borrowings for these same periods were $24,259,000 and $10,396,000, respectively, with weighted average annual interest rates (total interest divided by average daily borrowings) of 7.87% and 6.22%, respectively.

The maximum amount of commercial paper outstanding for 1978 and 1977, was $165,273,000 and $160,500,000, respectively. The average daily borrowings for these same periods were $113,414,000 and $88,967,000, respectively, with weighted average annual interest rates of 7.23% and 5.63%, respectively.

There were no notes payable outstanding during 1977; however, the maximum amount of notes payable outstanding for 1978 was $87,970,000. The average daily borrowings for this period was $41,402,000, with a weighted average annual interest rate of 8.23%. These notes are unrelated to the lines of credit referred to above.

Legal matters —

In March 1978, five resale customers filed a suit against the Company in Federal Court alleging violation of certain antitrust laws. The complaint seeks damages in excess of $23,000,000, the trebling of these damages and certain injunctive relief, and alleges that the Company (i) is engaging in anti-competitive behavior by charging more for wholesale electricity sold to the resale customers than the Company charges certain classes of its retail customers, and (ii) has taken actions alone and in concert with other utilities to prevent or limit such resale customers from obtaining bulk power supplies from other sources to reduce or replace the resale customers' wholesale purchases from the Company. In August 1978, the Federal Court granted the Company's motion to stay the action pending resolution of the Company's FERC resale rate filing which became effective in February 1976, and of other FERC proceedings involving bulk power contracts and substantially the same antitrust issues. The resale customers have asked the FERC to modify these contracts and to order the Company to provide additional transmission services to them.

The foregoing proceedings involve complex issues of law and fact, and although the Company is unable to predict their final outcome, it categorically denies the allegations of these resale customers.

In 1972 a charge was filed with the Federal Equal Employment Opportunity Commission ("EEOC") and a class action lawsuit was filed in Federal Court in 1974, both of which alleged that the Company had engaged in unlawful, discriminatory employment practices.

Although denying that it had engaged in any unlawful employment practices, the Company entered into a Conditional Settlement with the EEOC and the representatives of most of the class action plaintiffs which, on November 7, 1977, was submitted to the Federal Court for approval as a consent decree. The estimated cost of this settlement is initially $700,000 with the possibility of an additional estimated $300,000 in payment on individual awards after hearings.

If the settlement should not be approved and the case is tried, it is the opinion of Company counsel that the Company has a number of defenses which should be sustained by a court and which, among other things, have the effect of limiting monetary damages. The Company believes, based on a current analysis of the applicable law and facts, that the amount of any recovery for monetary damages, including back pay, should not have a material effect on the financial position of the Company.

Note 5 — Taxes on Income

As required by the CPUC and discussed in Note 1, no provisions are made for income tax reductions (net) which result from reporting certain transactions for income tax purposes in a period different from that in which they are reported in the financial statements, except for certain ITC discussed below, the retroactive adjustments to taxes on income resulting from the restatement discussed in Note 2 and the tax effects of the ECAC balancing account provisions.

Effective January 1, 1976, pursuant to FERC procedure, the Company began providing deferred income taxes for certain timing differences allocable to resale rates. The revenues related to such deferred income taxes are being collected subject to refund, as discussed in Note 4, pending action by the FERC.

ITC not deferred have been applied as a current reduction of income tax expense. Additional ITC, made available to the Company under the provisions of the Tax Reduction Act of 1975 and the Tax Reform Act of 1976, have been deferred and are being amortized to income tax expense ratably over the service lives of the properties generating such credits. Certain CPUC decisions could affect the Company's rights to utilize such additional ITC. The Company has requested, but has not yet received, a ruling from the Internal Revenue Service on this matter. Although the loss of the additional ITC would increase the Company's current income tax liability by $85,231,000 as of December 31, 1978, it would not materially affect previously reported net income for any of the applicable periods because only $2,787,000 has been amortized from February 1975 through December 1978.

Components of taxes on income, the deferred Federal and State portions of which have been revised from amounts previously reported, are set forth in the following table:

	Thousands of Dollars Year Ended December 31, 1978	1977
Current:		
Federal	$ (49,219)	$ (48,360)
State	3,567	1,233
	(45,652)	(47,127)
Deferred — Federal and State:		
Investment tax credit — net	32,568	26,886
Energy cost adjustment balancing account	(15,904)	81,101
Customer refunds (Note 2)	78,801	(5,315)
Other	2,208	1,345
	97,673	104,017
Total taxes on income	$ 52,021	$ 56,890
Taxes on income included in operating expenses	$ 72,803	$ 68,792
Taxes on income included in other income.	(20,782)	(11,902)
Total taxes on income	$ 52,021	$ 56,890
Differences between the federal statutory tax rate and the Company's effective tax rate are reconciled as follows:		
Federal statutory tax rate	48.0 %	48.0 %
Excess of tax over book depreciation	(3.4)	(6.0)
Allowance for debt and equity funds used during construction	(12.4)	(9.4)
Repair allowance	(4.7)	(2.9)
Administrative and general expenses capitalized	(2.7)	(2.3)
Investment tax credit — net	(8.4)	(6.6)
Ad valorem lien date adjustment	4.2	(0.5)
Federal deduction for state taxes on income	(2.7)	(3.5)
All other differences	(5.5)	(2.9)
State tax provision	4.7	4.5
Effective tax rate	17.1 %	18.4 %

Note 6 — Research and Development

Research and Development ("R&D") expenditures are expensed currently if they are of a general nature. Plant related R&D expenditures are accumulated in construction work in progress ("CWIP") until a determination is made whether or not such projects will result in construction of electric plant. If no construction of electric plant ultimately results, the expenditures are charged to operating expense. The balance of R&D expenditures included in CWIP at December 31, 1978 and 1977 was $17,178,000 and $13,331,000, respectively.

	Thousands of Dollars Year Ended December 31, 1978	1977
R&D expensed	$14,442	$12,710
R&D charged to CWIP — net	3,847	2,407
Total R&D expenditures	$18,289	$15,117

Note 7 — Retirement Plans

The Company's current pension program is based on a trusteed non-contributory pension plan. Company contributions are determined on the basis of a level premium funding method and prior service costs are funded. Pension costs are funded or reserved for on an actuarial basis and amounted to $32,236,000 and $27,689,000 for 1978 and 1977, respectively. Accumulated pension funds and reserves exceed vested benefits under the program.

Under the Employee Stock Purchase Plan adopted to supplement employees' income after retirement, employees may elect to contribute specified percentages of their compensation to a trustee for the purchase of Company Common Stock and the Company contributes to the plan an amount equal to one-half of the aggregate contributions of employees, less forfeitures. The Company's contribution amounted to $2,785,000 and $2,591,000 for 1978 and 1977, respectively.

The Tax Reduction Act of 1975 introduced a provision for an additional 1% ITC if the funds generated therefrom are invested in the purchase of employer securities for the benefit of employees and transferred into an Employee Stock Ownership Plan. Eligible securities include Common Stock or securities convertible into Common Stock. The Company has established a Tax Reduction Act Employee Stock Ownership Plan with respect to the years 1976 and 1977 and has issued in trust 102,262 shares of Common Stock during 1977 and 203,879 shares of Common Stock during 1978. The allocation of such shares to participants and the continuation of the Plan are contingent upon the receipt of a favorable ruling by the Internal Revenue Service that the Company is eligible for the additional 1% ITC.

Note 8 — Long-Term Debt Payable in Foreign Currency

The Company has entered into a financing agreement, as amended, with certain English banks pursuant to which it issued promissory notes payable in pounds sterling. These notes are secured by a pledge of the Company's customer accounts receivable. On June 28, 1976, the Company entered into forward exchange contracts with a United States bank to purchase, at various times from February 1979 through August 1983, pounds sterling to repay substantially all of the promissory notes.

Note 9 — Earnings Per Share

Primary earnings per share are based on the number of weighted average shares of Common and Original Preferred Stock outstanding and Common Stock Equivalents for funds held by the Employee Stock Purchase Plan Trustee in each period, giving effect to the participating provisions of the Original Preferred Stock, and after providing for cumulative preferred and preference dividend requirements. Fully diluted earnings per share also give effect to the dilution

which would result from the conversion of the Preference Stock, 5.20% Convertible Series, and the 3⅛% Convertible Debentures, Due 1980.

Note 10 — Subsidiary Companies

None of the Company's five wholly-owned subsidiaries is considered significant for financial reporting purposes. Mono Power Company ("Mono"), a non-public utility, is engaged primarily in the acquisition and development of mineral properties and interests therein. Mono has entered into agreements to conduct uranium, oil, coal, gas and geothermal exploration and development, substantially all of the costs and benefits of which are being reflected in the Company's energy costs.

Availability of Replacement Cost Data (Unaudited)

The Company is subject to the jurisdiction of certain regulatory commissions which authorize rates of return on the Company's investment in utility plant. Under current ratemaking policy, the Company recovers, through future depreciation charges, the historical investment in productive capacity. The ratemaking process does not allow the Company to recover the excess of replacement cost over historical cost which may be incurred in the future. However, when actual replacements of productive capacity are made, the related higher depreciation expense is recoverable under established regulatory practice.

Due to the cumulative impact of inflation, when the Company replaces an asset with one having an equivalent productive capacity, it is required to make a capital investment that is significantly greater than the historical cost of such asset reported in the Company's financial statements.

In compliance with reporting requirements of the Securities and Exchange Commission ("SEC"), additional replacement cost information is disclosed in the Company's annual report to the SEC on Form 10-K, which is expected to be available to shareholders after March 31, 1979, upon written request to the Company's Treasurer.

Southern California Edison Company

Capital Stock–Dividend and Price Information

Class and Series of Stock	Quarterly Dividends Paid Per Share (a)	High and Low Sales Prices ($)															
		Calendar Quarter — 1977								Calendar Quarter — 1978							
		1		2		3		4		1		2		3		4	
		High	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low
Original Preferred	0.56	23	20½	25¾	22¾	25⅞	24	27½	24	27¾	25¼	27	24⅞	27⅛	25	27⅛	24⅜
Cumulative Preferred:																	
4.08%	0.25½	13¼	12⅛	13	12	13½	11¾	13⅜	11⅝	12¾	11¾	12¾	10⅝	12⅝	11⅜	12¾	10½
4.24%	0.26½	13¾	12⅛	13¼	12¼	13⅞	12¼	13½	12	13⅜	11⅞	13⅛	11¼	13¼	11½	12¼	10½
4.32%	0.27	13¾	12¼	13¾	12⅜	14⅜	12½	13¾	12	13⅝	11¾	13½	11⅜	12⅞	11⅜	12⅞	10⅝
4.78%	0.29⅞	15½	13½	15⅛	13½	15¾	13⅞	15¼	13¼	14¾	13¼	14¾	12¾	14	12⅜	13¾	11⅜
5.80%	0.36¼	19¼	16⅞	18¾	17⅛	19⅜	17	18½	17	18	16½	18	15⅛	17¼	15¾	17½	15⅛
8.85%	0.553125	27½	25¼	27⅝	25⅜	27¾	25⅜	27⅜	25¼	27⅛	24⅝	25¾	23¾	26½	23½	26	22½
9.20%	0.57½	28¼	26⅛	27⅞	25¾	28¾	26⅞	28¼	26	27¼	25⅜	27	24½	27¼	24⅝	27	23½
$100 Cumulative Preferred:																	
7.325% (b)	1.83⅛	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
7.58%	1.89½	95	88½	95	89½	96¾	92⅛	94	88½	90	86½	88½	81⅛	90	79¼	86⅞	82
7.80% (b)	1.95	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
8.70%	2.17½	104¾	100	104½	100¾	108	101	105¾	99¼	104	100	103	94¼	103	93	101	91
8.96%	2.24	107	101	108¾	103	112	104	105½	101¾	106⅜	100¾	104	97⅞	106⅞	95¾	104	94⅝
Preference 5.20% Convertible	0.32½	17⅜	16	18¼	16⅝	18½	17¼	19	17	18¾	17¾	18⅞	16	19⅛	17⅜	19⅜	16¾
7.375% (b)	0.460938	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Common	0.56 (c)	24¼	21⅛	26¼	23	26⅜	24¾	27¼	24¼	26⅞	25	26¾	22⅞	27	25⅛	26⅝	23½

(a) Quarterly dividends were paid at the rates indicated in each quarter of 1978.

(b) There are no prices as these issues are private placements and shares are not traded.

(c) Quarterly dividend rate was increased to $0.62 from $0.56 per share effective with the January 31, 1979 payment.

Summary of Operations and Comparative Statistics of Progress 1968-1978

		1978	1977
Summary of Operations (a) *in thousands*	Operating Revenues	$2,328,798	$2,064,914
	Operating Expenses	2,004,197	1,734,192
	Energy Costs (b)	1,240,029	1,040,091
	Taxes on Income — Current and Deferred (b)	72,803	68,792
	Allowance for Debt and Equity Funds Used During Construction	78,421	60,238
	Interest Charges	182,658	161,078
	Net Income	251,683	251,979
	Earnings Available for Common and Original Preferred Stock	$ 202,226	$ 206,330
	Weighted Average Shares of Common and Original Preferred Stock Outstanding and Common Stock Equivalents	57,477	54,347
	Per Share Data:		
	Primary Earnings	$3.52	$3.80
	Fully Diluted Earnings	$3.38	$3.63
	Dividends Declared on Common Stock	$2.30	$2.06
Balance Sheet Data (a) *in thousands*	Gross Utility Plant	$6,810,891	$6,191,733
	Accumulated Provision for Depreciation	1,519,174	1,383,009
	Percent of Gross Utility Plant	22.3	22.3
	Long-Term Debt (includes current maturities) (c):		
	Bonds	2,418,212	2,255,216
	Debentures	75,046	75,135
	Other	17,953	20,023
	Preferred & Preference Stock	700,650	715,172
	Common Stock, Including Additional Stated Capital	547,166	470,374
	Additional Paid-in Capital	569,673	443,109
	Earnings Reinvested in the Business	$ 931,217	$ 862,956
	Capital Structure (percent):		
	Long-Term Debt:		
	Bonds	46.0	46.6
	Debentures	1.4	1.6
	Other	0.4	0.4
	Preferred & Preference Stock	13.3	14.7
	Common Equity	38.9	36.7
	Book Value Per Common Share	$32.57	$32.30
Operating and Consumption Data	Operating Capacity (kw) (d)	14,703,073	14,336,573
	Total Energy Requirement (kwh) (000)	63,877,116	63,344,706
	Percent Output:		
	Thermal	73.9	87.5
	Hydro-Company Plants	9.2	2.4
	Purchased Power & Other Sources	16.9	10.1
	Kilowatt-Hour Consumption (000)	57,027,035	57,726,273
	Number of Customers	2,986,545	2,900,856
	Average Annual Kwh Consumption Per Residential Customer	5,883	5,630
	Number of Employees	13,505	13,266
	Main System Peak (kw) (000)	11,997	11,247

(a) Certain data presented for the years 1972-1977 have been restated due to the circumstances described in Note 2 of the Notes to Financial Statements.

(b) Included in Operating Expenses.

1976	1975	1974	1973	1972	1971	1970	1969	1968
$1,846,540	$1,647,134	$1,360,959	$1,075,949	$ 927,674	$ 802,434	$ 720,661	$ 642,124	$ 588,829
1,539,400	1,380,528	1,108,249	843,530	709,724	612,732	535,846	482,663	440,646
916,131	824,826	541,890	344,990	240,135	192,982	143,475	126,216	118,901
59,506	46,623	70,618	46,496	44,542	38,542	38,635	36,480	37,592
47,610	26,773	16,163	10,190	7,152	15,859	17,007	17,471	10,007
144,368	126,185	112,959	97,728	91,752	82,308	77,633	68,246	58,760
226,798	176,781	160,344	146,110	135,648	127,297	127,495	107,869	99,894
$ 185,047	$ 137,177	$ 124,656	$ 117,268	$ 110,469	$ 105,752	$ 110,497	$ 95,152	$ 89,744
48,678	47,965	44,580	43,965	43,965	43,041	40,963	40,501	39,348
$3.80	$2.86	$2.80	$2.67	$2.51	$2.46	$2.70	$2.35	$2.28
$3.61	$2.75	$2.68	$2.57	$2.43	$2.37	$2.59	$2.27	$2.20
$1.68	$1.68	$1.68	$1.56	$1.56	$1.51½	$1.50	$1.40	$1.40
$5,658,433	$5,147,333	$4,766,175	$4,458,631	$4,233,067	$3,998,045	$3,737,837	$3,461,836	$3,188,708
1,258,327	1,149,311	1,051,024	958,210	851,910	779,409	707,928	649,702	592,366
22.2	22.3	22.1	21.5	20.1	19.5	18.9	18.8	18.6
2,055,966	2,012,597	1,863,951	1,640,349	1,705,139	1,584,840	1,484,840	1,384,840	1,210,000
75,224	75,313	75,401	75,490	75,579	74,902	74,987	74,987	74,987
20,671	25,968	14,327	6,871	7,991	7,991	438	—	—
612,753	612,753	562,753	512,753	437,753	362,753	362,753	262,753	262,755
442,741	395,709	395,709	362,376	362,376	362,376	337,360	337,360	324,857
427,422	350,503	350,503	316,636	316,636	316,636	243,437	243,437	202,599
$ 769,425	$ 671,548	$ 616,562	$ 569,938	$ 512,164	$ 470,754	$ 430,477	$ 381,040	$ 342,712
46.7	48.6	48.1	47.1	49.9	49.9	50.6	51.6	50.1
1.7	1.8	1.9	2.2	2.2	2.3	2.6	2.8	3.1
0.5	0.6	0.4	0.2	0.3	0.3	—	—	—
13.9	14.8	14.5	14.7	12.8	11.4	12.4	9.8	10.9
37.2	34.2	35.1	35.8	34.8	36.1	34.4	35.8	35.9
$30.67	$29.64	$28.50	$28.46	$27.14	$26.20	$24.72	$23.53	$22.09
14,065,748	13,656,648	13,494,849	13,447,095	12,615,665	12,458,165	10,904,845	10,238,627	9,277,515
59,427,973	56,279,231	55,105,988	57,730,121	55,686,776	52,672,084	49,674,757	46,344,845	42,905,380
75.2	76.2	75.2	84.9	86.6	80.0	82.5	79.1	88.3
4.3	8.4	10.0	9.0	6.4	8.4	9.2	12.7	8.2
20.5	15.4	14.8	6.1	7.0	11.6	8.3	8.2	3.5
53,685,378	51,327,508	51,089,981	54,092,934	52,309,906	48,856,493	45,881,076	42,601,606	39,365,088
2,814,403	2,749,680	2,691,691	2,626,492	2,566,341	2,497,342	2,438,584	2,383,251	2,330,751
5,650	5,596	5,541	5,885	5,777	5,642	5,240	5,031	4,609
13,024	12,940	13,468	13,927	13,269	12,831	12,299	11,911	11,090
11,081	10,193	9,997	10,253	9,815	9,350	8,274	7,804	7,425

(c) The years subsequent to 1971 include unamortized premium or discount related to each category of long-term debt.

(d) Includes 1,546,953 kw available from others in 1978 and 1977.

Board of Directors

Jack K. Horton	*Chairman of the Board*
Norman Barker, Jr.	*Chairman of the Board, United California Bank, Los Angeles, California*
Edward W. Carter	*Chairman of the Board, Carter Hawley Hale Stores, Inc., Los Angeles, California*
William B. Coberly, Jr.	*President, California Cotton Oil Corporation, Los Angeles, California*
Terrell C. Drinkwater	*Retired Airline Executive, Los Angeles, California*
Walter B. Gerken	*Chairman of the Board, Pacific Mutual Life Insurance Company, Newport Beach, California*
William R. Gould	*President*
Frederick G. Larkin, Jr.	*Chairman of the Executive Committee, Security Pacific National Bank, Los Angeles, California*
T. M. McDaniel, Jr.	*Corporate Director and Consultant (Retired President, Southern California Edison Company), San Marino, California*
Dorothy W. Nelson	*Dean and Professor of Law, University of Southern California Law Center, Los Angeles, California*
John V. Newman	*President, CBS-Sony California, Inc. (Citrus Production), Oxnard, California*
Gerald H. Phipps	*President, Gerald H. Phipps, Inc., General Contractors (Building Construction), Denver, Colorado*
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E. L. Shannon, Jr.	*President, Santa Fe International Corporation (Oil Service, Petroleum Exploration and Production), Orange, California*
H. Russell Smith	*Chairman of the Board, Avery International (Manufacturer of Self-Adhesive Products), San Marino, California*
Richard R. Von Hagen	*President, Lloyd Corporation, Ltd. (Real Estate Development and Production of Oil and Gas), Beverly Hills, California*

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William R. Gould	*President*
Howard P. Allen	*Executive Vice President*
H. Fred Christie	*Senior Vice President and Chief Financial Officer.*
David J. Fogarty	*Senior Vice President*
A. Arenal	*Vice President (System Development)*
J. H. Drake	*Vice President (Engineering and Construction)*
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A. L. Maxwell	*Vice President and Comptroller*
Jack B. Moore	*Vice President (Advanced Engineering)*
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Robert E. Umbaugh	*Vice President (Administration)*
G. E. Wilcox	*Vice President (Personnel)*
John R. Bury	*General Counsel*
Michael L. Noel	*Treasurer*
J. C. Bobek	*Secretary*

1979 Annual Shareholders' Meeting
The annual meeting of shareholders of Southern California Edison Company will be held at 10 a.m., Thursday, April 19, 1979, at the Company's Corporate Headquarters, 2244 Walnut Grove Avenue, Rosemead, California 91770. Telephone (213) 572-1212.

Statistical Supplement
A comprehensive financial and statistical supplement to this report is available in limited quantity. A copy may be requested by writing to the Treasurer, Southern California Edison Company, P.O. Box 800, Rosemead, California 91770.

Stock Transfer Agent
Southern California Edison Company
Rosemead, California

Registrar of Stock
Security Pacific National Bank
Los Angeles, California

Stock Exchange Listings
Common Stock:
New York Stock Exchange
Pacific Stock Exchange

Preferred and Preference Stocks:
American Stock Exchange
Pacific Stock Exchange

Ticker Symbol
SCE (Common Stock)

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