EL PASO ELECTRIC COMPANY

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1985 ANNUAL REPORT

1985 HIGHLIGHTS

	December 31, 1985		December 31, 1984	
Operating Revenues (000)	$ 339,591		$ 329,015	
Operating Expenses (000)	$ 256,295		$ 250,072	
Net Income (000)	$ 113,071		$ 108,286	
Net Income Per Common Share	$ 2.88		$ 2.88	
Dividends Paid Per Common Share	$ 1.49		$ 1.43	
Book Value Per Common Share	$ 16.19		$ 14.82	
Common Shares Outstanding	34,743,917		33,697,555	
Number of Common Shareholders	53,870		54,911	
Number of Customers	212,901		205,903	
Number of Employees	1,056		1,067	
Total System Peak Load	877,000	KW	819,000	KW
Net Generating Capacity for Peak	989,000	KW	989,000	KW
Average Annual Residential Use	5,735	KWH	5,755	KWH
Fuel, Purchased and Interchanged Power Expenses (000)	$ 131,367		$ 128,535	
Total Energy Sales	4,277,532	MWH	4,035,778	MWH
Gross Utility Plant (000)	$ 1,837,261		$ 1,548,772	

ANNUAL MEETING OF SHAREHOLDERS

All shareholders are invited to attend the Annual Meeting of Shareholders on Monday, May 19, 1986, at 10 a.m. El Paso time in The Westin Paso Del Norte, 101 South El Paso Street in El Paso, Texas.

Proxies for the meeting will be solicited by the Board of Directors 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.

ON THE COVER. Halley's Comet, which made its last appearance in 1910, is illustrated. At that time El Paso Electric was known as El Paso Electric Railway Company; the Company's revenues totaled $640,658; and the Company's total expenses were $369,056.

Photo courtesy of Joseph E. Zurlinden

DEAR SHAREHOLDER:

The electric utility industry has experienced transitional and sometimes turbulent times in the past five years. Many of the challenges that faced El Paso Electric Company as we prepared to enter the decade of the '80s are still with us today. They have, however, become more complex. Emerging technologies, changing demographics, and social, political and economic changes along with the ever-changing regulatory climate are still major concerns half a decade later.

El Paso Electric experienced one of its most challenging years in 1985. Because of the ever-changing nature of the industry, the Company must continually develop innovative methods to accomplish its primary missions and meet the challenges of not only the remaining '80s but also of the 1990s.

The primary missions of the Company continue to be service to customers, enhancement of shareholder investment and employee opportunity. These missions have not changed since our early days; they remain constant. What does change, however, are the methods, philosophies and outside factors, all of which are involved as we determine how we will continue to accomplish these missions.

THE PALO VERDE NUCLEAR GENERATING STATION

In 1985, after 15 years of planning and construction, El Paso Electric entered an exciting new age—the age of nuclear-generated energy. For the first time, electricity generated by a nuclear plant is flowing through El Paso Electric's transmission lines. More than 251 million kilowatt hours (KWH) of energy were received from the Palo Verde Nuclear Generating Station during 1985.

Evern R. Wall
President and
Chairman of the Board

After 50 weeks of power ascension testing, the Company declared Palo Verde Unit 1 to be in commercial operation on December 31, 1985. With the unit now in operation, El Paso Electric is well underway toward converting its fuel mix from a reliance on natural gas and oil. The goal is that by 1987, 80 percent of the energy used by area customers will be generated through the use of uranium and coal. When Units 2 and 3 of Palo Verde go on-line, that goal will be achieved.

On December 9, 1985, the Nuclear Regulatory Commission granted an operating license for Palo Verde Unit 2. Fuel loading of the unit was successfully completed on December 16, 1985. Testing is expected to take about 15 weeks less than that of Unit 1. The improvement results from the experience gained from Unit 1 which can be applied directly to the second identical unit. Unit 2 is expected to reach commercial operation during the third quarter of 1986.

Construction of Unit 3 is more than 99 percent complete. Fuel loading is scheduled for the first quarter of 1987 with commercial operation expected during the third quarter of that year.

With Unit 1 complete and providing electricity to customers, the next step will be to include the cost of the unit in the Company's rate base for revenue requirement purposes. Unit 1 has been accounted for in the past with approximately 60 percent excluded from rate base while about 40 percent was included in rate base as Construction Work in Progress (CWIP). Placing 100 percent of the unit in the rate base is necessary in order for the Company to recover the cost of the project over its useful life.

"...RATE DECREASE... ILLUSTRATES THE INCREASINGLY POLITICIZED TENOR OF TEXAS REGULATION..."
—Standard & Poor's

RATES AND REGULATION

Texas

During recent years, a major concern to the Company has been the rulings of the Public Utility Commission of Texas. In June 1985, El Paso Electric filed for a rate increase before the Commission. This filing followed a decision by the Commission in October 1984 ordering the Company to decrease its base rates by approximately $343,000 beginning in January 1985.

The result of the 1985 rate filing was again adverse. The Public Utility Commission's written decision issued on January 31, 1986, again called for the Company to reduce its base rates, this time by approximately $14.3 million. The Company has filed a motion for rehearing with the Texas Commission, and, unless the motion is substantially granted, the Company expects to appeal the Commission's decision to State District Court.

An additional result of the Commission's order was that both Standard and Poor's Corporation and Moody's Investors Service placed El Paso Electric on creditwatch. In making its announcement, Standard & Poor's stated that "the mandated rate decrease, despite the company's strained financial posture, illustrates the increasingly politicized tenor of Texas regulation in a gubernatorial election year."

Following this second rate order, the Company implemented a Contingency Cash Retention Plan. The plan calls for the deferral and delay of many projects which would have required cash outlays during the year. However, because of the Company's critical cash flow situation, plans are to again file for rate relief in Texas during the second quarter of 1986. The Company will seek recognition of Palo Verde Unit 1 in rate base and recovery of the full costs applicable to the Company's 15.8 percent share of the unit and related common facilities as well as sufficient amount of CWIP on Units 2 and 3.

"THE AREA OF FINANCIAL MANAGEMENT HAS BEEN WELL RUN..." —Touche Ross

New Mexico

In February 1986, the New Mexico Public Service Commission granted the Company a $7 million increase in base rates instead of the original $5.9 million agreed upon in the 1983 stipulation. The increase will be effective with bills rendered in April 1986. The order was the result of a stipulated agreement between the parties in the case recognizing Unit 1 in commercial operation thus allowing the unit to be included in rate base. As a result, New Mexico customers will be benefiting from the lower fuel cost associated with nuclear fuel during 1986.

Rate Moderation Efforts

An innovative approach to rate making emerged in 1985. Rate Moderation Task Forces were formed in Texas and New Mexico for the purpose of developing a negotiated rate plan to help eliminate "rate shock" once Palo Verde is placed in the customer rate base.

The task forces comprised of Company representatives, along with large electric users, utility regulators and consumer representatives, began meeting in the spring of 1985. Unfortunately, agreements were not reached in Texas or New Mexico. However, the New Mexico Commission ordered the Company to file a Rate Moderation Plan with hearings to be held this summer. While agreements were not reached, the task force concept is a good one and the Company will continue to work with both states toward establishing viable rate moderation plans.

"EPE HAS BEEN AGGRESSIVE IN ITS USE OF PURCHASED POWER..." —Touche Ross

ENERGY EFFICIENCY

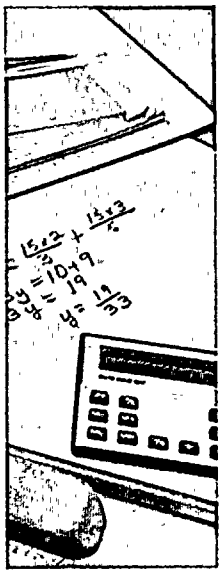
The efficient use of electric energy by our customers continued to receive major emphasis during 1985. El Paso Electric, through its energy management program, is continuously striving to increase customer awareness of how to use electric energy efficiently.

Through the Company's energy management efforts, various educational campaigns informing the public of the efficiency of electricity were developed. Activities included the participation in area home shows along with assisting in commercial developer shows. Home and commercial energy audits were offered and used by customers who were interested in reducing their overall utility bills.

OFF SYSTEM PURCHASES

The Company's diverse transmission system, which includes three major 345,000 volt transmission lines, has become increasingly important as a path for energy purchases from neighboring utilities.

El Paso Electric searches the western United States on a hourly basis for opportunities to purchase electricity at less than local generating costs. The efforts have been very successful, as off system purchases produced savings to our customers of more than $25 million in 1985.



EXTERNAL REVIEW

In compliance with Texas public utility law and an order from the Public Utility Commission of Texas, El Paso Electric underwent a management audit in 1985. The audit, which each Texas public utility must undergo at least once every 10 years, was conducted by Touche Ross & Co. The study began in February and was completed in August.

The overall view of the Company was positive. However, a number of recommendations for changes were made by Touche Ross. Management is reviewing the recommendations for cost-effective implementation. The following are portions of the final report taken from the Executive Summary:

Executive Management and Organization "The Board of Directors is actively involved in the affairs of El Paso Electric. Many of the individual members have been on the Board for an extended period, thus providing for continuity, as well as the familiarity with the evolution of the Company. Several new members have been added to the Board in recent years thus providing for a fresh perspective on El Paso Electric and its decision making."

"...A STRONG COMMITMENT TO CUSTOMER SERVICE..."
—Touche Ross

System Planning and Design "Transmission system planning has become increasingly important to El Paso Electric because of the high cost of its local generation, however the recent Amrad Project and the current Arizona Interconnection Project provide the additional transmission capability to enable the Company to take greater advantage of purchased power. El Paso Electric has been aggressive in its use of purchased power to the extent that in 1984 it accounted for approximately 38 percent of total energy delivered."

Engineering and Construction "In recent years the engineering group has achieved several milestones from its participation in the Amrad and Arizona Interconnection Projects. These projects are both 345-kv transmission lines extending in excess of 170 miles from Amrad and 210 miles for the Arizona Interconnection Project. Both these projects have been significant undertakings by El Paso Electric and provided the engineering group experience in areas where such experience was neither broad nor deep."

Fuels Management "The Resource Development/Contracts Department was able to negotiate a lower price for gas during contract negotiations and take advantage of market conditions. This renegotiation resulted in lower costs being passed along to ratepayers."

Financial Management "The area of financial management has also been well-run and is another example of where creative financial techniques have been developed, which have benefited ratepayers through lower capital costs. We found that El Paso Electric has done an effective job of meeting the dramatic financing requirements of Palo Verde. Through a series of innovative and timely financing requirements, El Paso Electric has been able to successfully arrange for financing of the project to date."

Customer Service and Public Relations "Based on our review of these functions, El Paso Electric has made a strong commitment to customer service and to the El Paso community in general. Most available information suggests that El Paso Electric has made positive efforts toward improving the quality of service to its customers. The Company has a strong sense of community commitment and is actively involved in a variety of organizations and causes at all levels."

Franklin Land and Resources "El Paso Electric has been particularly innovative in its creation and operation of Franklin Land and Resources and has utilized this subsidiary as a means to reduce taxes and provide a contribution to corporate earnings which provides cash and strengthens the financial profile of El Paso Electric."

"...PARTICULARLY INNOVATIVE IN ITS CREATION...OF FRANKLIN LAND..."
—Touche Ross

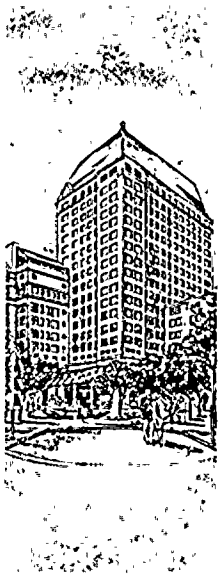
FRANKLIN LAND & RESOURCES, INC.

The year 1985 was productive for El Paso Electric Company's wholly owned subsidiary Franklin Land & Resources, Inc., which made major positive impacts on the El Paso community.

The restoration by Franklin Land of one of El Paso's downtown landmarks—the Cortez building—has been completed and the completion and opening of the historic Paso del Norte Hotel, which was first opened in 1912, will take place this spring.

The restored Cortez provides office space for some of the most prestigious businesses in El Paso; among them, an international stock brokerage firm and an international accounting firm. Interest in the restored landmark is evidenced by the fact that 65 percent of the building's space had been leased as of December 31, 1985.

In addition, the Cortez Annex, a seven-story parking garage has been constructed adjacent to the Cortez. A major savings bank has located its downtown office on the ground floor of the Cortez Annex and the other floors will be used for parking by the tenants of the Cortez and the general public.



A few blocks from the Cortez, the 17-story tower of The Westin Paso Del Norte enhances the downtown skyline. Westin Hotels was chosen as the management firm for the Paso del Norte because of its sound reputation as one of the most successful hotel chains in the world. When completed, The Westin Paso Del Norte will add approximately 380 guest rooms to El Paso's downtown. The hotel will be one of the most elegant and prestigious in the Southwest.

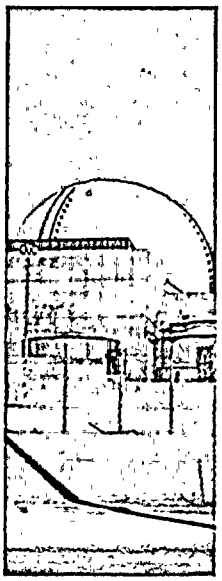
The restoration of the two El Paso landmarks has added new life to the El Paso community through the redevelopment of Downtown El Paso.

"THE COMPANY HAS A STRONG SENSE OF COMMUNITY COMMITMENT..."
—Touche Ross

SOUTHWEST GROWTH AND DEVELOPMENT

Studies indicate the El Paso-Las Cruces area will continue to experience steady population growth. According to the City of El Paso projections, the city's population will increase by more than 12 percent by 1990 and by more than 35 percent by the year 2000.

Because of this expected growth, it is of the utmost importance that El Paso Electric be prepared to serve its customers. El Paso Electric has been charged with the responsibility of providing residents in the Company's service area with efficient, reliable and economical electric energy. Since 1901 that responsibility has been met. With the emergence of new challenges facing the electric utility industry, innovative methods of facing those challenges must also be developed. El Paso Electric is ready for those challenges. Through the continuing adherence to the Company's Plan for Action, along with the development and implementation of a new Strategic Plan, El Paso Electric customers can be assured of the reliable service they have received in the past.



The manner by which a company meets its challenges depends greatly on the dedication of its employees and board of directors. El Paso Electric is fortunate to possess a hard working and conscientious work force as well as a dedicated and involved Board of Directors. It is with these two positive forces that our needs were met in 1985, and it is with these two positive forces that El Paso Electric will meet its challenges in the future.

The challenges are there; we will go forth and meet them together.

Evern R. Wall
President and Chairman of the Board

CORPORATE INFORMATION

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.

DIVIDEND REINVESTMENT

The Company's Dividend Reinvestment and Stock Purchase Plan is a convenient method of investing dividends and optional cash payments in new shares of Company Common Stock without payment of commissions and fees. An enrollment card may be obtained by writing the Company Secretary.

COMMON STOCK SHAREHOLDERS

The Common Stock of the Company is held in every state and the District of Columbia, some U.S. territories and many foreign countries. The number of Shareholders on December 31, 1985, was 53,870. Our records indicate that about 78 percent of the Company's Shareholders own less than 500 shares each.

TOLL-FREE TELEPHONE

The Company maintains a toll-free telephone system for the convenience of Shareholders who may have questions or inquiries concerning their accounts. If you are calling from within Texas the number is 1-800-592-1634. Elsewhere in the U.S. the number is 1-800-351-1621.

TRANSFER AGENT

Harris Trust Company of New York, 110 Williams Street, New York, New York 10038 (Common and Preferred Stock).

MBank El Paso, N.A., Post Office Box 1072, El Paso, Texas 79958 (Common Stock Only).

A COMPLETE COPY OF THE COMPANY'S MOST RECENT FORM 10-K REPORT, FILED WITH THE SECURITIES AND EXCHANGE COMMISSION INCLUDING THE FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULES SET FORTH THEREIN, WILL BE MADE AVAILABLE TO SHAREHOLDERS WITHOUT CHARGE UPON WRITTEN REQUEST TO:

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

OFFICERS OF THE COMPANY

Evern R. Wall
President and Chairman of the Board (28)
Billye E. Bostic
Executive Vice President (38)
Charles Mais
Vice President (31)
Ignacio R. Troncoso
Vice President (16)
Lawrence M. Downum, Jr.
Vice President (25)
William J. Johnson
Vice President and Controller (8)
William W. Royer
Vice President and Treasurer (5)
Joseph E. Wasiak*
Vice President (8)
James P. Maloney*
Vice President
Theta S. Fields
Secretary (35)
Robert N. Hackett
Assistant Vice President (15)
Robert L. Corbin
Assistant Vice President (37)
Richard E. Farlow
Assistant Treasurer (37)
Cecelia R. Shea
Assistant Secretary (28)

*Elected Vice President, February 1986

DIRECTORS OF THE COMPANY

Evern R. Wall
President and Chairman of the Board (11)
Wilfred E. Binns
Contractor; Owner, Binns Construction and Realty (3)
Robert H. Cutler
Chairman of the Board, Cutler Corporation (16)
H.M. Daugherty, Jr.
Chairman of the Board and Chief Executive Officer, MBank El Paso N.A. (3)
Leonard A. Goodman, Jr.
Chartered Life Underwriter/General Agent, John Hancock Companies (7)
Ben L. Ivey
Farming (16)
Josefina A. Salas-Porras
Secretary-Treasurer, Sunland Motor Sports, Inc. (7)
Tom C. Simpson
President, Simpson Farms Inc.; President, Simpson Cattle and Feed Company (3)
Tad R. Smith*
Attorney, Kemp, Smith, Duncan and Hammond; Counsel for the Company (25)

*Elected Vice Chairman of the Board, January, 1986

Years of Service ( ).

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended December 31, 1985

Commission File Number 0-296

El Paso Electric Company

(Exact name of registrant as specified in its charter)

Texas (State or other jurisdiction of incorporation or organization)	74-0607870 (I.R.S. Employer Identification No.)
303 North Oregon Street, El Paso, Texas (Address of principal executive offices)	79901 (Zip Code)

Registrant's telephone number, including area code: 915-543-5711

None of the registrant's securities is registered pursuant to Section 12(b) of the Act.

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, no par value
(Title of Class)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes _X_ No ____.

As of February 28, 1986, the aggregate market value of the voting stock held by non-affiliates of the registrant was $540,663,056.

As of February 28, 1986, there were outstanding 34,777,835 shares of Common Stock, no par value.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for the annual meeting of its shareholders to be held on May 19, 1986 are incorporated by reference into Part III of this report.

DEFINITIONS

The following abbreviations or acronyms used in this report are defined below:

Abbreviations or Acronyms	Terms
AFUDC	Allowance for Funds Used During Construction
APS	Arizona Public Service Company
CD	Certificate of Deposit
Common Plant	The facilities common to all three Palo Verde Units
Company	El Paso Electric Company
Copper	Copper Power Station
CWIP	Construction Work in Progress
DOE	United States Department of Energy
FERC	Federal Energy Regulatory Commission
Four Corners	Four Corners Project (and Plant)
Fuel Use Act	Powerplant and Industrial Fuel Use Act of 1978, as amended
IID	Imperial Irrigation District, an irrigation district in Southern California
KV	Kilovolt
KW	Kilowatt(s)
KWH	Kilowatt-hour(s)
LADWAP	Los Angeles Department of Water and Power
LIBOR	London Interbank Offering Rate
MCF	Thousand cubic feet
MW	Megawatt(s)
NASDAQ	National Association of Securities Dealers Automated Quotations System
Newman	Newman Power Station
New Mexico Commission	New Mexico Public Service Commission
NRC	Nuclear Regulatory Commission
Palo Verde Station or Palo Verde Project	Palo Verde Nuclear Generating Station
PNM	Public Service Company of New Mexico
Rio Grande	Rio Grande Power Station
SCE	Southern California Edison Company
SCPPA	Southern California Public Power Authority
SPS	Southwestern Public Service Company
SRP	Salt River Project Agricultural Improvement and Power District
Subsidiary	Franklin Land & Resources, Inc., a wholly-owned subsidiary of the Company
TEP	Tucson Electric Power Company
Texas Commission	Public Utility Commission of Texas
TNP	Texas-New Mexico Power Company, a subsidiary of TNP Enterprises, Inc.
Tribe	Navajo Indian Tribe
1986 Proxy Statement	Company's definitive proxy statement for the annual meeting of shareholders to be held on May 19, 1986.

TABLE OF CONTENTS

PART I

* The information required by this Item has been omitted from this Annual Report to Shareholders.

PART I

Item 1. Business

General

The Company was incorporated in Texas in 1901. It distributes electricity through an interconnected system to approximately 213,000 customers in El Paso, Texas and in an area in the Rio Grande Valley in Texas and New Mexico. The Company's principal executive offices are located at 303 North Oregon Street, El Paso, Texas 79901 (telephone 915-543-5711).

The Company's service area extends approximately 110 miles northwesterly from El Paso to the Caballo Dam in New Mexico and approximately 120 miles southeasterly from El Paso to Van Horn, Texas. The service area has an estimated population of 660,000, including approximately 500,000 people in the metropolitan area of El Paso. Copper smelting and refining, oil refining, garment manufacturing, cattle raising and agriculture are important industries in El Paso, which is also an important transportation and distribution center. The Company's largest customers include a copper refinery, a smelter, and a steel fabricator in El Paso, and important military installations, namely the U.S. Army Air Defense Center at Ft. Bliss in El Paso and the White Sands Missile Range and Holloman Air Force Base in New Mexico.

The Company's major franchises are with the cities of El Paso, Texas and Las Cruces, New Mexico, such franchises expiring in 2001 and 1993, respectively. Although the franchises contain no expressed renewal provisions, the Company believes, but has no assurance, that they will be renewed.

During 1985, approximately 75% of the Company's total sales were derived from Texas, 18% from New Mexico and 7% from FERC jurisdictional customers. Sales to residential, small commercial and industrial, and large commercial and industrial customers accounted for approximately 32%, 31%, and 14%, respectively, of the Company's operating revenues, while sales to public authorities and sales for resale contributed approximately 16% and 7%, respectively. In 1985, a wholesale customer accounted for 6.1% of operating revenues. No retail customer accounted for more than 3% of operating revenues. The effect of seasonal sales by quarter are insignificant to the Company's annual operating revenues, but the third quarter of each calendar year traditionally contributes approximately 30% of annual revenues due to the climate in the Company's service area. (See Note "M" of "Notes to Consolidated Financial Statements.")

The Company attained an all-time total system peak load of 877 MW on August 6, 1985. In 1984, the Company's total system peak load was 819 MW. In 1985 and 1984, the native system peak load was 778 MW and 776 MW, respectively. The Company periodically makes long-range projections of system peak load and estimates future sources of power that may be used to supply the system requirements. The projected annual peak load growth rate for the Company's service area during the 1986-1994 time period is approximately 3.8%. Despite this projected growth rate, the Company may experience for a short period of time excess generating capacity when Palo Verde Unit 3 becomes operational due to the cumulative size of the Company's interest in the three nuclear generating units at the Palo Verde Station. Nevertheless, the Company believes it is essential to participate in the Palo Verde Station, not only to meet future load growth needs, but also to diversify its fuel mix. (See "Construction and Financing Programs — Construction Program — Palo Verde Station.")

In 1981 and 1982, as part of an effort to increase sales of capacity, the Company entered into firm power sales agreements with IID and TNP, respectively. The IID agreement provides for sales of electric energy ranging from 90 to 100 MW from 1986 to 1990. In 1984, the IID agreement for 100 MW was extended to 1992 with an option date of 1986 to extend the agreement for up to an additional 10 years at amounts of 60 to 150 MW. The TNP agreement provides for sales of electric energy ranging from 37 MW in 1986 to 95 MW in 1993. A dispute has arisen between the Company and TNP, principally regarding the amount of the capacity required to be purchased under the contract. TNP has alleged that its obligation can be reduced by 10% per year. The dispute is currently in arbitration, the outcome of which cannot be predicted at this time.

The Company had 1,056 employees as of December 31, 1985. Approximately 30% of the employees are covered by a collective bargaining agreement that is effective through February 1987.

Industry and Company Conditions

Several factors continue to significantly influence the operations and financial results of electric utilities, particularly those companies which either have major construction programs in progress or which have recently completed such construction programs. These factors include: (i) difficulties in obtaining adequate and timely rate relief, including difficulties in obtaining regulatory approval of full inclusion in rate base of the costs of new generating facilities; (ii) difficulties in meeting government imposed environmental requirements and other regulatory measures, including NRC licensing requirements; (iii) controversies over the safety and use of nuclear power; and (iv) substantial capital outlays for larger and more complex generating facilities.

The Company's major construction project is, and for a number of years has been, related to its 15.8% interest in the three 1,270 MW nuclear generating units which comprise the Palo Verde Station, located near Phoenix, Arizona. At December 31, 1985, the Company's investment in Palo Verde aggregated $1.3 billion (including $425 million of AFUDC), representing 68% of total assets. Construction of Palo Verde Units 1 and 2 has been completed, and Unit 3 is estimated to be approximately 99% complete at December 31, 1985. The Company's share of estimated costs (as of December 31, 1985) to complete Palo Verde (including startup and testing costs) aggregates $201 million, including AFUDC of $81 million. Units 1 and 2 have both been licensed for full power operation by the NRC (Unit 2 being subject to a 5% power restriction pending the completion of certain tests to the satisfaction of the NRC), and Unit 1 was placed in commercial operation by the Company in December 1985. Units 2 and 3 are scheduled to achieve commercial operation during the third quarters of 1986 and 1987, respectively.

With the Palo Verde construction program nearly completed, and with Unit 1 being in commercial operation, the Company believes that Unit 3 will be completed on a timely basis and that Units 2 and 3 will be brought into commercial operation on schedule. That being the case, the principal factor which will affect the future financial condition and operations of the Company will be obtaining adequate and timely rate relief together with financing the effects, if any, of any rate moderation plans into which the Company enters.

During 1986, the Company intends to seek rate relief pursuant to normal rate making procedures, as well as rate moderation plans and a sale and leaseback transaction with respect to all or a portion of the Company's undivided ownership interest in Palo Verde Unit 2. Management believes, based upon existing law and pertinent facts and circumstances, that the Company is entitled to adequate rate relief and that such rate relief will be obtained on a timely basis, although such rate relief cannot be predicted with certainty. Based upon the Company's projections, it will need adequate rate relief in 1987 in order to generate positive cash flow from operations.

The Company obtained a $7 million increase in its New Mexico jurisdictional base revenues, effective with bills rendered beginning in April 1986.

The Company will be required to obtain approximately $98 million of external financing during the remainder of 1986 (in addition to the $70 million financing described below) to meet continuing commitments for cash construction expenditures (including nuclear fuel acquisition payments), sinking fund requirements, scheduled debt repayments and a portion of common stock dividends. On February 11, 1986, the Company completed a $70 million financing by means of a five-year, secured bank loan. Management believes that the Company can obtain the external financing required in 1986 and for future years.

In November 1985, the utility regulatory bodies of the Palo Verde participants' states released a first phase report prepared by the outside consultants in connection with the on-going Palo Verde management and construction audit. For the recommendations contained in the report, and for other

information relating to the consideration by the Texas and New Mexico Commissions of the qualification for inclusion in rate base of the full amount of Palo Verde costs, see "Rates and Regulation — Palo Verde Management and Construction Audit." Management believes that Palo Verde has been constructed in a prudent manner and that overall the construction costs incurred in connection with Palo Verde qualify for inclusion in rate base.

In December 1985 the Financial Accounting Standards Board issued an exposure draft that would, if enacted in its present form, significantly change generally accepted accounting principles for regulated entities. The exposure draft proposes revised accounting requirements for phase-in or rate moderation plans, regulatory disallowances of plant costs and plant abandonments. (See Note "A" of "Notes to Consolidated Financial Statements.")

For a more complete discussion of the above matters, see "Rates and Regulation," "Construction and Financing Programs" and Note B of Notes to Consolidated Financial Statements.

Rates and Regulation

Regulatory Authorities

Texas. The rates and services of the Company in Texas municipalities are regulated by the municipalities and in unincorporated areas by the Texas Commission. The Texas Commission has exclusive de novo appellate jurisdiction to review municipal orders and ordinances, and its decisions are subject to judicial review. (See Note "B" of "Notes to Consolidated Financial Statements.")

New Mexico. The New Mexico Commission has authority over the Company's rates and services in New Mexico, the issuance of securities by the Company and certain other matters directly affecting the operations of the Company.

Federal. The Company is subject to regulation by the FERC in certain matters that include wholesale electric rates and the issuance of securities. In addition, Congress has enacted energy legislation which, among other things, establishes national standards for consideration by state regulatory agencies in determining utility rates and imposes other requirements on the operations of utilities, including the Company. Under certain circumstances, the FERC may order interconnection, wheeling and pooling.

Rate Matters

Texas

1984 Rate Case. In October 1984, the Texas Commission issued its final order in the Company's 1984 rate increase request, resulting in a decrease of approximately $343,000 in non-fuel base rates. The Company appealed the Texas Commission's order to state district court in Travis County, Texas, which dismissed the appeal in June 1985 on a procedural point. The Company appealed the dismissal to the state court of appeals, and oral arguments on the appeal were held March 5, 1986. The Company is awaiting a decision from the appellate court.

1985 Rate Case. In June 1985, the Company filed for a rate increase in its Texas service area based on a 1984 test-year. The rate increase request was submitted in the alternative, depending on the regulatory treatment of the Company's interest in Palo Verde Unit 1. The Company sought recognition and inclusion in rate base of Palo Verde Unit 1 as a commercially operating unit and inclusion of 25% of 1984 CWIP costs for Palo Verde Units 2 and 3. The increase requested over the Company's total Texas adjusted test-year revenues was $61,223,000 or 25.06%. In the alternative, if Palo Verde Unit 1 was not considered as in commercial operation at the end of the test-year, the Company requested inclusion of approximately 80% of 1984 CWIP costs for all three units of Palo Verde. This alternative requested an increase over the Company's total adjusted test year revenues of $67,488,000 or 27.63%. On November 6, 1985, the Texas Commission dismissed the Company's proposed in-service treatment of Palo Verde Unit 1 and considered the rate request based on the Company's alternative "CWIP" filing. On January 29, 1986, the Texas Commission issued its final order in the case. The order

authorized the Company to place in rate base 50% of test-year Palo Verde CWIP, granted the Company a 15.0% return on common equity (which was the Texas Commission's findings as to the current cost of equity) and made certain accounting adjustments, the combined effects of all of which resulted in a decrease of approximately $14,300,000 in non-fuel base rates. As part of the Texas Commission's order, the Company will refund to its Texas customers approximately $5,200,000, which was the cumulative balance of the Company's fuel overrecovery as of July 1985 plus accrued interest thereon. The refund is scheduled to be made by means of an adjustment to the Company's fixed fuel factor rate, which will reduce cash collections by the amount of the refund, but which will have no material effect on net income. See "Fuel Cost Adjustment Provisions" below.

The Company filed a motion for rehearing which was denied by the Texas Commission on March 5, 1986, and the Company has appealed the final order to state district court in Travis County, Texas. The new rates are scheduled to go into effect in the spring of 1986.

In its final order, the Texas Commission also ordered the Company to defer expensing the cost of owning, operating and maintaining its share of Palo Verde Unit 1 and Common Plant and to continue to accrue related AFUDC on Unit 1 and Common Plant, effective with the date of commercial operation of Unit 1, as defined by the Texas Commission. The recovery of these deferred costs will be included in the rate order at the time the Unit is placed in service for rate making purposes; subject, to the Company's establishing that the deferred costs were reasonable and necessary. Management believes that Palo Verde has been constructed in a prudent manner and that overall the construction costs incurred with respect to Palo Verde qualify for inclusion in rate base. Should either the Texas Commission or the New Mexico Commission order a disallowance of a material portion of such construction costs, based upon a finding of imprudency or excess capacity, the Company would vigorously contest such an order by court action. See "— 1986 Rate Case" and "Palo Verde Management and Construction Audit" below.

In response to the Texas Commission's order, Standard & Poor's Corporation and Moody's Investors Service, Inc. placed the Company on "creditwatch with negative implications." According to Standard & Poor's, "the mandated rate decrease, despite the Company's strained financial posture, illustrates the increasingly politicized tenor of Texas regulation in a gubernatorial election year."

1986 Rate Case. The Company expects to file during 1986 for a rate increase in its Texas jurisdictional rates, seeking inclusion in rate base of the full costs applicable to the Company's share of Palo Verde Unit 1 and Common Plant and a sufficient amount of CWIP on Palo Verde Units 2 and 3 to protect the financial integrity of the Company, without giving effect to the contemplated sale and leaseback of Palo Verde Unit 2 (see "Construction and Financing Programs — Future Financing") . Any adjustments in rates resulting from this filing would be effective beginning in 1987. Unit 1 has not been determined to be in commercial operation for rate making purposes by the Texas Commission. On February 19, 1986, the Texas Commission adopted, on an emergency basis, a new rule which sets forth the criteria for determining when a new nuclear generating unit attains commercial operation and is therefore eligible for rate making treatment as plant in service. The criteria include successful completion of all preoperational and start-up testing programs (including an uninterrupted run of at least 100 hours at a 95%-100% level), a finding by the Texas Commission that the unit and associated transmission facilities are supplying to the utility's customers their full share of its rated power and can do so with the single-most critical transmission line out of service, satisfactory explanation of all delays of over 100 hours in the start-up testing program and of all NRC violations incurred during the start-up period, together with demonstration that acceptable measures have been taken to prevent recurrence, and a finding by the Texas Commission that the unit is supplying electricity to the utility's customers, with output scheduled to the load dispatcher subject to plant availability.

Based upon the factors discussed in "Construction and Financing Programs — Construction Program — Palo Verde Station," the Company concluded in December 1985 that power from Unit 1 could be reliably scheduled for service to its customers and placed Unit 1 and Common Plant in commercial operation at that time. The Company believes that Unit 1 satisfies substantially all of the

criteria of the new rule so as to be in commercial operation for rate making purposes at December 31, 1985. The Company has filed testimony to support the Company's determination that Unit 1 should be considered as in commercial operation at December 31, 1985 and expects a ruling from the Texas Commission with respect to the commercial operation status of Unit 1 prior to its 1986 rate filing. The Company believes, but has no assurance, that the Texas Commission will find Unit 1 to be in commercial operation at December 31, 1985 for rate making purposes.

New Mexico

In September 1983, the Company entered into a stipulated settlement of its 1983 New Mexico rate case which provided for a two-stage increase in the Company's jurisdictional rates. The amount of the second stage of the increase, which provided for an additional $5,900,000 annual revenue increase effective with the commercial operation of Palo Verde Unit 1, was challenged by certain of the parties to the 1983 stipulation. After negotiation, the Company and all parties to the 1983 stipulation reached an agreement, which was approved by the New Mexico Commission in February 1986 and which allows the Company a $7,000,000 increase in its New Mexico jurisdictional non-fuel base revenues, beginning with bills rendered in April 1986, and includes all of Palo Verde Unit 1 and one-third of Common Plant in rate base. The agreed upon increase specifically provides for recovery of Unit 1 expenses and that the Company cease capitalizing such expenses effective with the new rates.

FERC

In December 1984, the FERC approved the settlement of the Company's February 1984 rate filing with that commission. The settlement (effective September 22, 1984) provided for an annual increase of approximately $323,000 in the Company's FERC jurisdictional rates, the inclusion in rate base of approximately $1.5 million of Palo Verde CWIP costs, and a 15.75% return on common equity. The Company expects to file during the first quarter of 1986 for an additional rate increase with respect to its FERC jurisdictional revenues.

Rate Moderation Matters

In March and April 1985, respectively, the New Mexico and Texas Commissions created task forces whose purposes were to develop plans which would phase-in or moderate the rate increases which would otherwise result from the inclusion in rate base of the full costs applicable to Palo Verde. Neither task force was able to reach the requisite unanimous agreement on a rate moderation plan, and both were disbanded in 1985. The New Mexico Commission, however, has established a new docket to address the same issues as the New Mexico task force addressed and has set a hearing regarding rate moderation for June 23, 1986. Pursuant to an order by the New Mexico Commission in this new docket, the Company filed a rate moderation plan on March 13, 1986. The intention of the New Mexico Commission is to enter an order establishing a rate moderation plan by the third quarter of 1986.

The Company believes that viable rate moderation plans are in the best interest of the Company's shareholders and customers and intends to continue to work with its Texas and New Mexico regulators toward establishing such plans. The key objective of a viable rate moderation plan is to enable the Company to maintain the traditional utility pricing objective of rate continuity in an effort to avoid possible adverse effects on the Company's load growth, while providing a level of cash rate relief that is adequate to meet the Company's needs. The Company believes that some form of rate moderation is the most likely form of rate relief to occur in the near-term.

Palo Verde Management and Construction Audit

In 1984, the utility regulatory bodies of Texas, New Mexico, Arizona and California agreed to conduct an independent audit of Palo Verde management and construction costs and a power distribution study of the Project. The audit will examine whether construction costs incurred in connection with the Palo Verde Project have been prudently incurred and qualify for inclusion in the

respective rate bases of the investor-owned participants. The power distribution study will focus upon power exchanges and other options for distributing any short-term excess power generated at Palo Verde. On November 27, 1985, the utility regulatory bodies released a first phase report prepared by the outside consultants in connection with the audit. The report identifies certain areas recommended for further study, including startup costs and schedule, construction and engineering costs, system planning and project management. The report estimates that the "direct construction costs" of Palo Verde will total approximately $5.9 billion of which approximately $3.1 billion will be subject to further study. In addition, the report recommends a review of the AFUDC costs associated with Palo Verde, as well as other certain indirect costs. The report does not express an opinion regarding the reasonableness of specific actions related to Palo Verde. Rather, it is intended to define subsequent detailed studies which may include recommendations regarding the reasonableness of such actions. The issue of the reasonableness of specific actions related to Palo Verde may relate to whether the Company may recover Palo Verde's costs from the Company's customers. The next phase of the audit began in March 1986, with recommendations expected in late 1986 or 1987.

The Texas Commission has interpreted the Texas Public Utility Regulatory Act, as amended in 1983, to require utilities subject to the jurisdiction of the Commission to establish for rate making purposes the prudency of the planning and management of a construction project prior to allowing the utility to earn a rate of return on that project in the form of CWIP. With respect to an in service rate case, the Texas Public Utility Regulatory Act requires the utility to establish the reasonableness of the costs incurred in connection with a construction project as a condition to the inclusion of such costs in rate base.

The Company believes that Palo Verde is one of the better managed nuclear power construction projects in the nation. During an NRC hearing with respect to a full power operating license for Unit 1, the Palo Verde Project was commended for its quality and management. Unit 1 was completed at a cost of about 12% below the average for 23 other nuclear projects built during the same period. The time elapsed between the first concrete pour and fuel loading of Unit 1 was one year less than the average time for such other nuclear projects. Based upon the foregoing and other factors, the Company believes that Palo Verde has been constructed in a prudent manner and that its regulators will ultimately conclude that the construction costs incurred in connection with Palo Verde qualify, from a prudency standpoint, for inclusion in the Company's rate base. However, an adverse result in the audit is possible, and the Company cannot predict what actions its regulators might take in response to any adverse audit recommendations. Should either the Texas Commission or the New Mexico Commission order a disallowance of a material portion of the construction costs, based upon a finding of imprudency, or excess capacity, the Company would vigorously contest such an order by court action.

Fuel Cost Adjustment Provisions

Tariffs applicable to all of the Company's sales contain fuel cost adjustment provisions. Texas utilities are not permitted to automatically pass through to customers changes in fuel costs. The Texas Public Utility Regulatory Act requires a public hearing and order by the Texas Commission before any changes in fuel costs can be passed through to customers. The Company's Texas retail customers are presently being billed under a fixed fuel factor approved by the Texas Commission in connection with the Commission's order in the Company's 1985 rate filing. This fuel factor will remain in effect until the earlier of the Company's next general rate case or Commission ordered fuel reconciliation. On February 21, 1986, the Texas Commission passed a new fuel rule which would subject a utility's fixed fuel factor to a monthly reduction, as opposed to an annual reduction, if the utility had materially over-recovered its allowable fuel costs under its existing fuel factor.

Rate tariffs in New Mexico currently contain fuel and purchased power cost adjustment provisions designed to recover costs above 30 mills per KW delivered. The Company's new tariffs effective with bills rendered in April 1986 pursuant to the stipulated increase discussed above (see "Rate Matters — New Mexico") will contain a fixed fuel factor similar to Texas. The fixed fuel factor was based on projected 1986 fuel costs including Palo Verde nuclear fuel costs and will remain in effect until

April 1987 unless there is an earlier Commission ordered reconciliation due to a material over or under collection of allowable fuel costs under the existing fuel factor.

Rate tariffs currently applicable to FERC jurisdictional wholesale customers contain appropriate fuel and purchased power cost adjustment provisions designed to recover those costs in excess of costs included in base rates.

Construction and Financing Programs

Construction Program

The Company's estimated construction costs for 1986 through 1989 set forth in the table below are approximately $366 million, consisting of approximately $290 million cash and approximately $76 million in related AFUDC, net of deferred tax. The estimated costs are based upon direct cash costs and capitalized indirect costs through December 31, 1985, in the case of Palo Verde Unit 1, and to the presently scheduled commercial operation dates of Palo Verde Units 2 and 3. The estimated costs were prepared as of March 14, 1986, and the Palo Verde Station's estimated costs assume an average annual inflation rate of 7% and give effect to the revised commercial operation dates for Palo Verde Units 2 and 3. (See "Palo Verde Station" below). For a number of reasons, including compliance with governmental procedures and regulations, changes in the Company's plans, and changes in the plans of participants in joint projects, actual costs may vary from the construction program estimates set forth below. Such estimates are reviewed and modified from time to time to reflect changed conditions.

	1986	1987	1988	1989
		(In thousands)		
Production:				
Palo Verde Station(1)	$ 83,200	$ 18,000	$ 1,100	$ —
Four Corners Environmental	200	—	—	—
Other	5,800	4,500	5,000	7,300
Transmission:				
Palo Verde Station	8,100	9,400	—	—
Other	17,200	16,500	19,300	10,300
Distribution	13,700	18,800	22,100	18,000
General Plant	4,100	2,500	2,300	2,500
AFUDC(2):				
Palo Verde Station	51,300	29,100	600	—
Four Corners Environmental	100	—	—	—
Other	1,900	4,100	5,000	6,700
Deferred Tax on AFUDC(3)	(12,300)	(7,600)	(1,300)	(1,500)
Total	$173,300	$ 95,300	$54,100	$43,300

(1) Does not include acquisition costs for nuclear fuel. (See "Energy Sources — Nuclear Fuel.")

(2) AFUDC has been calculated using an estimated accrual rate of 11.5%. Certain amounts of CWIP have been allowed in the Company's rate base ($350.6 million in Texas and $1.5 million for FERC) or made the basis of extraordinary cash rate relief ($53.3 million in New Mexico) and the appropriate amounts have been excluded from the CWIP balance used as a base for calculating AFUDC. (See "Rates and Regulation.") AFUDC on major projects has been compounded on a semi-annual basis.

(3) Deferred tax is provided on the borrowed portion of AFUDC and will effectively reduce utility plant to a net of tax rate for rate making and depreciation purposes.

Net utility plant at December 31, 1980, was $632,951,000. Gross additions to plant, including construction work in progress, for the five years ended December 31, 1985, totaled $1,140,577,000 (the largest portion of which was $908,432,000 for the nuclear plant at the Palo Verde Station). Net utility plant at December 31, 1985, was $1,693,704,000. (Includes capitalized nuclear fuel of approximately $54,000,000 leased from the nuclear fuel trust. See "Energy Sources — Nuclear Fuel.")

Palo Verde Station. The Company has a 15.8% undivided interest in the three 1,270 MW nuclear generating units and the Common Plant related to such units at the Palo Verde Station near Phoenix,

Arizona. The participants in the Palo Verde Project include the Company and six other utilities, those being Arizona Public Service Company, Southern California Edison Company, Public Service Company of New Mexico, Southern California Public Power Authority, Salt River Project Agricultural Improvement and Power District and the Los Angeles Department of Water and Power. Participants share cost and generating entitlements in the same proportion as their percentage interests in the generating units. APS serves as Project Manager and Operating Agent for the Palo Verde Station. In February, 1977 and November, 1978, respectively, the New Mexico Commission and the Texas Commission issued certificates of convenience and necessity for the Company's participation in Units 1, 2 and 3 at the Palo Verde Station.

The Company's share of each of the Palo Verde units is approximately 200 MW. Construction of Units 1 and 2 has been completed, and, as of December 31, 1985, Unit 3 was estimated to be approximately 99% complete.

On December 31, 1984, the NRC granted the participants in the Palo Verde Project a full power operating license for Unit 1, valid for a period of 40 years from the date of issuance. The license, however, restricted operation of Unit 1 to power levels not to exceed 5% of full power without specific NRC approval. Fuel loading of Unit 1 was completed on January 11, 1985, and on May 25, 1985, the first nuclear chain reaction was achieved at Unit 1. On May 30, 1985, the NRC removed the 5% power restriction on the full power operating license for Unit 1. In late December 1985, Unit 1 completed 100 continuous hours of operation at a 95%-100% power level. Based upon this run, the completion of substantially all preoperational and start-up testing programs and the fact that Unit 1 was supplying electricity to the Company's customers, the Company concluded that power from Unit 1 could be reliably scheduled for service to customers and placed Unit 1 and Common Plant in commercial operation at that time. See "Rates and Regulation — Rate Matters — Texas — 1986 Rate Case."

On December 9, 1985, the NRC granted a facility operating license for Palo Verde Unit 2 to the Palo Verde participants. The license, valid for a period of forty years from the date of issuance, authorizes the operation of Unit 2 at full power. Pending completion satisfactory to the NRC of certain tests and other items, however, the license restricts operation of Unit 2 to power levels not to exceed 5% of full power without specific NRC approval. Nuclear fuel loading for Unit 2 was completed on December 16, 1985. Unit 2 currently is undergoing post core hot functional testing, and its first nuclear chain reaction is expected to be achieved in April 1986. Fuel loading of Unit 3 is scheduled during the first quarter of 1987.

The receipt of the facility operating license for Palo Verde Unit 2 later than previously expected, combined with other factors, resulted in the announcement on January 14, 1986 of a revision in the projected commercial operation dates of Units 2 and 3. Palo Verde Units 2 and 3 are now projected to achieve commercial operation during the third quarters of 1986 and 1987, respectively. Palo Verde Units 2 and 3 had been previously scheduled to achieve commercial operation during the second quarters of 1986 and 1987, respectively. The revised schedule did not cause any increase in the Company's estimated direct costs for its share of the Palo Verde Station.

The table below sets forth the Company's estimated cumulative costs, (including the cost of start-up and testing) of its share of the Palo Verde Station (plus the Company's share of the cost of related switchyard and transmission facilities), based upon the presently scheduled commercial operation dates of the Palo Verde Units, and the costs actually incurred by the Company through December 31, 1985. Such table does not, however, include the Company's share of the estimated cost of nuclear fuel. (See "Energy Sources — Nuclear Fuel.") The estimated costs, prepared as of March 14, 1986, assume an average annual inflation rate of 7% and are based upon direct cash costs and capitalized indirect costs through December 31, 1985, in the case of Palo Verde Unit 1, and to the presently scheduled commercial operation dates of Palo Verde Units 2 and 3.

	Actual Costs Through December 31, 1985	Estimated Cumulative Costs Through 1986	1987	1988
			(In thousands)	
Nuclear Plant	$ 861,700	$ 944,900	$ 962,900	$ 964,000
Related AFUDC	418,100	467,600	493,700	494,300
Transmission Lines & Switchyard	22,700	30,800	40,200	40,200
Related AFUDC	6,900	8,700	11,700	11,700
Deferred Tax on AFUDC	(85,400)	(97,200)	(103,900)	(104,000)
Total	$1,224,000	$1,354,800	$1,404,600	$1,406,200

Future Financing

The Company will be required to obtain approximately $98 million of external financing during the remainder of 1986 (in addition to the $70 million financing described below) to meet continuing commitments for cash construction expenditures (including nuclear fuel acquisition payments), sinking fund requirements, scheduled debt repayments and a portion of common stock dividends. On February 11, 1986, the Company completed a $70 million financing by means of a five-year, secured bank loan. Management believes that it can obtain the external financing required in 1986 and for future years.

In order to meet its 1987-1989 cash construction requirements (including nuclear fuel acquisition payments), mandatory preferred stock redemptions, long-term debt maturities and dividend requirements, the Company presently estimates that approximately $715 million cash will be required. The Company intends to meet this cash requirement through a combination of external financings and internally generated funds, which management believes will be provided through rate relief (including rate moderation plans). The Company is considering a sale and leaseback transaction with respect to a portion of its undivided ownership interest in Palo Verde Unit 2 (see below), which, if consummated, would substantially satisfy the Company's cash requirements for the 1987-89 time period. Management believes that the Company will secure adequate and timely rate relief in 1987 and thereafter, although such rate relief cannot be predicted with certainty. Based upon present projections, and without considering the effect of the contemplated Palo Verde Unit 2 sale and leaseback transaction, the Company will need rate relief in 1987 in order to generate positive cash flow from operations. See "Rates and Regulation — Rate Matters" for information regarding the 1984 and 1986 rate decisions of the Texas Commission, rate cases which the Company plans to file during 1986, recent rate relief obtained in New Mexico and rate moderation efforts which the Company is considering as another means to obtain adequate rate relief for the 1987-1989 time period. (See Note "B" of "Notes to Consolidated Financial Statements.")

Although management believes that the Company will be able to obtain the necessary external financing during the 1987-1989 time period, the cost to the Company of such financing may be substantially increased over what it otherwise would be, unless adequate and timely rate relief is obtained during that time period. The terms of such external financing may also be affected by other factors, including market conditions and the credit ratings of the Company's securities. External financing by the Company is also subject to the restrictions in the Company's Restated Articles of Incorporation and First and Second Mortgage Indentures discussed below, which restrictions, to date, have not adversely affected the Company's ability to finance.

Without adequate and timely rate relief, the earnings and interests coverage tests described below will be adversely affected. The Company, without such rate relief or sufficient external financing, might have to consider a curtailment of its construction program, the disposition of part of its interest in the Palo Verde Station, the elimination or reduction of other operating expenses, which could ultimately have an adverse effect upon customer service, and the re-evaluation of dividends on common stock. Whether, and to what extent, a disposition of the Company's interest in the Palo Verde station could be effected is uncertain and, if effected, whether and to what extent such disposition or

any resulting impairment of service would have a material adverse effect on the Company would depend upon the circumstances of the particular situation, including the degree and duration of, and the public and regulatory reaction to, the impairment of service.

In an effort to reduce its cost of capital and thereby achieve a form of rate moderation, the Company is actively pursuing a sale and leaseback transaction in 1986 of all or a portion of its undivided ownership interest in Palo Verde Unit 2, whereby Unit 2 and an appropriate portion of Common Plant would be sold at a price which would be confirmed by appraisal as fair market value and then leased back to the Company on a long-term basis for a stipulated basic rent. Although there can be no assurance that such a sale and leaseback transaction will be consummated, the sale proceeds to the Company of such a transaction with respect to all of the Company's undivided ownership interest in Unit 2, or a substantial portion thereof, would satisfy all or a substantial portion of the Company's external financing requirements for 1986 through 1989. Because such a transaction would be designed to reduce the Company's annual cost of capital, and, therefore, its need for rate relief, the Company believes that such a transaction will have a positive effect on the Company's ability to obtain rate relief.

The Company is also aggressively seeking to increase sales of capacity and energy in an effort to increase revenues.

With respect to external financing, the Company is limited by the restrictions described below contained in its Restated Articles of Incorporation and First and Second Mortgage Indentures, which restrictions have not, to date, impaired the Company's ability to issue securities.

The Company's Restated Articles of Incorporation provide that, unless consented to by the holders of preferred stock, additional shares of preferred stock may not be issued unless certain tests are met with respect to (i) net earnings of the Company available for preferred dividends, (ii) after-tax earnings available for interest, amortization, and preferred dividends, and (iii) the sum of junior stock capital and, if the Company so elects, surplus. Assuming a dividend rate of 11.25% on additional shares of preferred stock, the most restrictive of said tests, (iii) above, would have permitted the issuance of approximately $245,500,000 in preferred stock at December 31, 1985.

In addition, the Company's Restated Articles of Incorporation provide that, unless consented to by the holders of preferred stock, the aggregate of unsecured long-term debt shall not exceed 10% of the total of the Company's outstanding secured debt, capital and surplus. At December 31, 1985, the Company would have been permitted to issue approximately $60,700,000 in additional unsecured long-term debt.

The Company's First Mortgage Indenture permits the issuance of additional first mortgage bonds to the extent of 60% of the value of unfunded net additions to the Company's utility property, provided net earnings available for interest during a recent twelve-month period were at least twice the annual interest requirements on all bonds to be outstanding and on all prior lien debt. At December 31, 1985, unfunded net additions totaled $896,600,000 which was sufficient to permit the issuance of $537,900,000 principal amount of new bonds; but assuming an interest rate of 10.25% on any new first mortgage bonds, the net earnings test would have limited the principal amount of additional first mortgage bonds issuable at December 31, 1985, to approximately $217,000,000.

The Company's Second Mortgage Indenture permits the issuance of additional second mortgage bonds on the basis of 40% of the value of unfunded net additions to utility property. At December 31, 1985, unfunded net additions totaled $711,600,000 which was sufficient to permit the issuance of $284,600,000 principal amount of additional second mortgage bonds.

Short-Term Obligations

At December 31, 1985, the short-term obligations of the Company consisted of notes payable to banks and commercial paper which totaled $21,000,000. The Company also maintained informal lines of credit which totaled approximately $143,000,000 at December 31, 1985 and which provide for the

payment of lines of credit fees of various negotiated amounts. Of the $21,000,000 of notes payable and commercial paper outstanding at December 31, 1985, there was $13,000,000 outstanding under the Company's lines of credit.

The amount of short-term obligations which the Company may incur is regulated by the FERC. The FERC has authorized the Company to incur short-term obligations with maturities no later than December 31, 1986, in an amount not to exceed $200,000,000 outstanding at any one time.

For a description of short-term obligations of the Subsidiary, see Note "H" of "Notes to Consolidated Financial Statements."

Facilities

As described below, the Company currently has a net generating capacity of 1102 MW, consisting of 246 MW at Rio Grande, 477 MW at Newman, 69 MW at Copper, an entitlement of 110 MW from Four Corners and an entitlement of 200 MW from Palo Verde Unit 1.

The Company's all-time total system peak load is 877 MW which was recorded in August, 1985, as compared with the previous total system peak load of 819 MW recorded in July, 1984. The peak of 877 MW includes 767 MW of native system load and 110 MW of contract off-system load.

Rio Grande Power Station. Rio Grande, located in New Mexico adjacent to the city of El Paso, consists of three steam-electric generating units which have an aggregate capability of 246 MW when operating entirely on natural gas. When interstate natural gas at the station is curtailed, the units operate primarily on fuel oil, which increases operating and maintenance expenses. (See "Energy Sources.")

Newman Power Station. Newman, located in El Paso, consists of three steam-electric units with an aggregate capability of 266 MW and one combined-cycle unit with a capability of 211 MW. The units regularly operate on natural gas, but are capable of also operating on fuel oil. If they were to operate entirely on fuel oil, operating and maintenance costs would increase and capacities would be lower. (See "Energy Sources.")

Copper Power Station. Copper, consisting of a 69 MW combustion turbine capable of operating on fuel oil or natural gas and used for peaking purposes, was placed in service in June 1980 on a leased site in El Paso. The station has been classified under the Fuel Use Act as an existing facility, which allows the station to burn natural gas. Since such classification, the station has operated primarily on intrastate natural gas. (See "Energy Sources.")

Four Corners Project. The Company has an undivided 7% interest in Units 4 and 5 at Four Corners located in northwestern New Mexico. Each of the coal-burning generating units have the capability of 739 MW. For emergencies each Unit is rated at 784 MW. Both units are located adjacent to a surface-mined supply of coal and are jointly owned by the Company, APS (the Operating Agent for Four Corners), TEP, PNM, SCE and SRP. The Company's entitlement of 110 MW is used for the Company's base load to the maximum extent possible.

The Company owns a 230-mile 345 KV transmission line from Newman to Albuquerque, New Mexico, at which point the Company's entitlement from Four Corners is delivered from 150 miles of transmission lines owned by PNM. This 345 KV transmission line regularly carries power from Four Corners and provides a major interconnection with the other five participants in Four Corners. The Company also owns an undivided interest in a 200-mile 345 KV transmission line from Newman across southern New Mexico to Greenlee, Arizona. This line provides the Company with interconnection capability with TEP's system and for the Company's entitlement from Four Corners and also provides added stability, flexibility, and reliability to the Company's system. The Company and TEP have entered into an interconnection agreement which includes emergency transmission service.

Four Corners is located on land leased from the Tribe. The Company is, therefore, dependent in some measure upon the willingness and ability of the Tribe and certain Federal agencies to protect this

property, and means of access thereto, against attempted interference by others. It is also possible that the Tribe or certain possible adverse claimants may, from time to time, seek to abrogate or, in the case of the Tribe, renegotiate certain provisions of the lease in order to secure more favorable terms and for the United States Congress or the Secretary of the Interior to change the laws, rules and regulations governing Indian lands. Under certain circumstances such action could result in impairment or termination of certain provisions of the lease. (See " — Four Corners Litigation" below.) In addition, the Company's rights under the lease may be subject to possible defects (including possible prior conflicting grants or encumbrances not ascertainable because of inadequacies in the record system of the Bureau of Indian Affairs and the Tribe and the possible inability of the Company to resort to legal process to enforce its rights against the Tribe without congressional consent). In the opinion of Kemp, Smith, Duncan & Hammond, counsel to the Company, such rights under the lease are adequate for the Company's use of Four Corners, and the likelihood that any such possible defects in the Company's rights under the lease will result in material adverse interference with the Company's use of Four Corners is not a substantial risk.

Four Corners Litigation. In April 1985 the United States Supreme Court affirmed a decision of the United States Court of Appeals for the Ninth Circuit, thereby upholding the authority of the Navajo Tribe to impose taxes on non-Indian businesses pursuant to certain possessory interest and business activity tax resolutions adopted by the Navajo Tribal Council in 1978. As a result, the participants in the Four Corners Plant, including the Company, will be liable for the payment of Navajo taxes, either directly or indirectly, through the fuel supply agreement with the coal supplier to the Four Corners Plant, effective as of the 1978 date of enactment of the taxing resolutions, except to the extent that the participants or the coal supplier are relieved from payment by virtue of tax waiver or tax forgiveness provisions contained in the lease agreement for the Four Corners Plant.

The plant site lease agreement for the Four Corners Plant contains provisions whereby the Tribe agreed not to impose certain taxes directly or indirectly on the participants' ownership or operation of the plant or on the coal supplier to the plant (which conducts its mining operations within the Navajo Reservation). Snell & Wilmer, legal counsel to the Operating Agent for the Four Corners Plant, is uncertain whether the tax waiver provisions in the Four Corners Plant lease agreement would allow the participants to prevail in nullifying any attempt by the Tribe to impose the possessory interest tax against the coal supplier to the plant (see below).

Effective April 25, 1985, the coal site lease agreement between the Tribe and the coal supplier to the Four Corners Plant was amended. In that amendment, the Tribe forgave all business activities taxes and possessory interest taxes which may have accrued against the Four Corners Plant participants and the coal supplier prior to April 25, 1985. Accordingly, notwithstanding the uncertainty as to the scope of the tax waiver provisions in the plant site lease agreement, the amendment to the coal site lease agreement forgives the portion of the possessory interest tax that may have accrued against the coal supplier between 1978 and the effective date of the amendment.

Notwithstanding the April 1985 amendment to the coal site lease agreement, the Navajo Tax Commission has assessed the coal supplier to the Four Corners Plant for possessory interest taxes accruing prior to the effective date of that amendment. The coal supplier has commenced administrative proceedings to contest these assessments. Snell & Wilmer, legal counsel to the Operating Agent for the Four Corners Plant, does not believe that the position adopted by the Tribe is meritorious.

The Tribe has also assessed a possessory interest tax on the coal supplier to the Four Corners Plant for the period beginning April 25, 1985. Pending the resolution of the issue of whether the Four Corners Plant site lease agreement contains a waiver for the imposition of this tax, the tax will be paid into escrow by the coal supplier pursuant to the provisions in the amendments to its lease. The Company's share of the possessory interest tax sought to be imposed against the coal supplier is approximately $242,000 per year. The dispute will be heard by the Secretary of the Interior; however, the funds paid into escrow will not be released until the matter is decided by a federal court.

The 1985 amendment to the coal site lease agreement also increased royalty payments to the Tribe in return for certain contractual and other concessions including, among others, an amendment to the Four Corners Plant site lease agreement providing for a formula for pricing rights-of-way for future transmission lines, a pricing formula for a supply of water for the Four Corners Plant in the event the participants' water resources are reduced as a result of certain adjudication currently pending in the New Mexico state courts (see second succeeding paragraph) and an additional area for coal ash disposal, equipment storage and construction lay down. (See "Energy Sources — Coal.")

The Company believes, but has no assurance, that any increased costs to the Company, as a participant in the Four Corners Plant, incurred as a result of the collection from the coal supplier to the plant by the Tribe of the possessory interest tax and the increased royalties will be recoverable directly through fuel adjustment clauses or as a recovery of operating expenses in subsequent rate proceedings. (See "Rates and Regulations — Fuel Cost Adjustment Provisions.")

The participants in Four Corners have been joined as defendants in a suit filed by the State of New Mexico in March 1975, in state district court in New Mexico, against the United States of America, the City of Farmington, New Mexico, the Secretary of the Interior as Trustee for the Navajo and other Indian tribes, and certain other defendants. The suit seeks adjudication of all the water rights of the San Juan River Stream System in New Mexico, which, among other things, supplies the water used at Four Corners. Recognition of certain water claims of the Indian tribes could substantially increase the cost of water at Four Corners, but the Company believes that there is no practical risk that any such claims would materially adversely interfere with the operation of Four Corners.

Palo Verde Station. For information regarding the Company's undivided 15.8% interest in Units 1, 2 and 3 at the Palo Verde Station, see "Industry and Company Conditions," "Rates and Regulation," and "Construction and Financing Programs — Construction Program — Palo Verde Station." For a description of nuclear fuel acquisition, see "Energy Sources — Nuclear Fuel."

Palo Verde Litigation. Both groundwater and surface water in Arizona areas important to the operation of the Palo Verde Station have been the subject of inquiries, claims and legal proceedings which will presumably require a number of years to resolve.

In connection with the construction and operation of the Palo Verde Station, the Project Manager has entered into contracts with certain municipalities granting the Project Manager the right to purchase on behalf of the participants in Palo Verde effluent for cooling purposes at Palo Verde. The validity of the primary effluent contract has been challenged in a suit by the Salt River Pima-Maricopa Indian Community (the "Community") against the Department of the Interior (the federal agency alleged to have jurisdiction over the use of such effluent) and additional defendants, including the Company. The portion of the action challenging the effluent contract has been stayed while the Community litigates its claims against the Department of the Interior and other defendants for wrongful exclusion from SRP, a federal reclamation project.

In November 1982, certain operators of farms located in the vicinity of the Palo Verde site filed a lawsuit in Maricopa County Superior Court claiming prior rights to effluent to be delivered to Palo Verde under the primary and secondary effluent contracts. In December 1983, an owner of the land in the river basin from which the effluent to be received under the primary contract is alleged to be derived filed a complaint in the United States District Court for the District of Arizona challenging the primary effluent contract. The latter action was dismissed in November 1985. That dismissal has been appealed to the United States Court of Appeals for the Ninth Circuit. The Project Manager joined with another Palo Verde participant in bringing an action in Arizona state court against the plaintiffs in the two foregoing lawsuits, seeking a declaratory judgment as to rights to effluent under Arizona law. Such declaratory judgment action was consolidated in the Arizona state court with the lawsuit filed in November 1982. In October 1985, the state court ruled in favor of the Palo Verde participants in these consolidated lawsuits, holding that the effluent contracts are neither void, unenforceable, nor enjoinable for the reasons raised in the consolidated lawsuits by the parties adverse to the Palo Verde participants (the "Adverse Parties"). The Adverse Parties have appealed that decision to the Arizona Court of Appeals. The Project Manager and certain Palo Verde participants, including the Company, have cross-appealed.

On November 22, 1985, several municipalities which are parties to the primary effluent contract filed an action in Maricopa County Superior Court against certain of the Adverse Parties seeking a declaration that the primary effluent contract is valid notwithstanding claims asserted by those Adverse Parties that approval of the effluent contract exceeded the municipalities' legal authority and that the effluent contract violates the laws and public policy of Arizona. The Project Manager and SRP were named as indispensable parties. The Project Manager and SRP have answered the municipalities' complaint, alleging that there is no controversy because the Adverse Parties' claims are barred by applicable legal and equitable principles and alternatively seeking a declaration of the validity of the effluent contract. All parties have moved for summary judgment. A hearing on those motions is scheduled for April 21, 1986. On March 20, 1986 the Adverse Parties sought leave to amend their answer to assert numerous conterclaims and join additional parties as counter defendants, including the Company and all of the other Palo Verde participants. The proposed counterclaims allege that the primary effluent contract is invalid because it violates Arizona municipal law, Arizona water law, certain water supply agreements involving the municipalities, and various other provisions of Arizona law. The Palo Verde participants will respond to the proposed amendment in a timely manner.

Although the foregoing matters remain subject to further evaluation, the Project Manager expects that the described litigation will not have a materially adverse impact on the completion, licensing or operation of Palo Verde.

The Project Manager anticipates that existing water supplies in certain parts of Arizona will be augmented by Colorado River water upon completion of the Central Arizona Project (now scheduled to deliver water to Phoenix by mid-year 1986). Although the Project Manager has been granted an allocation of this water by the Secretary of the Interior, it is expected that reasonably priced water will remain in short supply in Arizona, that uncertainties in applicable water law as applied to pertinent facts and circumstances may persist for some time, and that the Palo Verde Station, which will be a highly visible large water consumer and which includes a number of out-of-state utilities, may become a principal target of conflicting claims to present water supplies. Nevertheless, the Project Manager for the Palo Verde Station believes that acceptable supplies will be available to the Palo Verde generating units throughout their useful lives.

Palo Verde Liability and Insurance Matters. The Palo Verde participants currently have insured against public liability claims resulting from nuclear energy hazards to the full $655 million limit on liability under Federal law (such law being commonly referred to as the "Price-Anderson Act"). The maximum available private insurance of $160 million has been purchased, and the remaining $495 million has been provided through a mandatory industry-wide retrospective assessment program, under which the Palo Verde participants, collectively, could be assessed charges up to $5 million for each Palo Verde Unit licensed by the NRC (of which the Company's share would be 15.8%) in the event the total liability arising from any nuclear incident involving any licensed facility in the nation exceeds the $160 million private insurance. In the event of more than one incident, the potential $5 million assessment per licensed unit would apply to each incident, subject to a maximum assessment in any one year of $10 million per licensed unit (the Company's share of which would be 15.8%) for all incidents. The insureds under the liability insurance include Palo Verde participants and "any other person or organization with respect to his legal responsibility for damage caused by the nuclear energy hazard". Such nuclear liability insurance coverage does not apply to damage to the plant facilities.

To cover possible damage to the Palo Verde facilities, the Palo Verde participants maintain nuclear property damage and decontamination insurance in the aggregate amount of $1.135 billion. The Company has also secured insurance against the increased cost of generation or purchased power resulting from the accidental outage of a nuclear unit. The Company will be insured, after a 26-week deductible period, for up to $395,000 per week for its share of Units 1 and 2 (and Unit 3 when it is placed in service) for 52 weeks and up to 50% of such weekly amount for an additional 52 weeks.

In addition to the above-described policies of insurance, the Palo Verde participants are parties to an indemnity agreement with the NRC. This agreement contains an undertaking by the NRC to indemnify the Palo Verde participants "from public liability arising from nuclear incidents which is in excess of the level of financial protection required of" the Palo Verde participants but not in excess of

$560 million. The indemnity agreement is not currently operative and will remain inoperative unless or until the level of financial protection (*i.e.*, the aggregate amount of primary and secondary levels of liability protection) required of the Palo Verde participants falls below $560 million.

The authority of the NRC under the Price-Anderson Act to enter into indemnity agreements covering new nuclear facilities not now in operation or under construction will expire on August 1, 1987. This limited expiration of authority, if not modified by Congress, would have no effect upon the financial protection and indemnity agreements in effect for plants now in operation or under construction, such as Palo Verde. Nonetheless, this expiration date has served as a catalyst for proposals to amend the Price-Anderson Act in a variety of ways. Some would simply extend the indemnity authority for an additional ten years in order to preserve the viability of the nuclear option for future expansion of the nation's generating capacity. However, other proposals, if adopted, could apply to existing plants now licensed for operation, such as Units 1 and 2, by eliminating or altering the limitation of liability or by increasing the maximum amount of retrospective annual premiums which could be assessed. Several bills to extend the expiring provisions and to amend or eliminate other provisions of the Price-Anderson Act have been offered in both the Senate and the House of Representatives. The response of Congress to these proposals cannot be predicted, nor is it certain that Congress will act in the near future.

Palo Verde Decommissioning Plan and Fund. For information regarding the obligations of the Company to plan and fund, over the service life of Palo Verde, it's share of the estimated costs to decommission Palo Verde, see Note "C" of the Notes to Consolidated Financial Statements. The Company believes that all costs associated with nuclear plant decommissioning will be recoverable through future rates.

Environmental Matters

The Company's operations are subject to stringent environmental protection measures imposed under federal and state laws and regulations, some of which have required substantial expenditures for pollution control technology. The Company believes that Rio Grande, Newman and Copper are currently in compliance with such laws and regulations.

Four Corners has been particularly affected by such environmental protection measures, and installation of costly retrofit particulate and sulfur dioxide control equipment has been required at an approximate cost to the Company of $32,800,000. It has also been necessary to obtain variances or stipulations for certain aspects of Four Corners operations. The initial variances were granted because state authorities found that emissions from Four Corners did not cause violation of air quality standards and that there was no reasonably available technology that would allow Four Corners to meet emissions limitations. Certain variances, relating to the emission of nitrogen oxides by the two units at Four Corners in which the Company has an undivided 7% interest, expired on May 13, 1985. Petitions for further variances for these units have been timely filed by the Operating Agent for Four Corners with the New Mexico Environmental Improvement Board, and applicable regulations provide for stays of enforcement pending final determinations with respect to such petitions. The Company cannot currently predict whether these petitions will be granted. Other state permits, relating to surface and ground water standards, contain various compliance dates and schedules which largely appear (though not beyond question) to be achievable.

The Federal Clean Air Act Amendments of 1977 may require installation of "the best available retrofit technology" on existing sources located near certain federally protected areas in which visibility is an important attribute. The Four Corners Plant is one such source. The installation is to occur as expeditiously as practicable, and, in any event, within approximately five years after revision of the applicable state implementation plan. The full significance of the visibility provisions to the Four Corners Plant is difficult to predict pending finalization of state and Federal implementing regulations.

Problems of interpreting and complying with the various measures described above, and the evolution of new measures (including any measures which are intended to address the "acid rain" problems afflicting other utilities but which could impact the Company as well), require continuing involvement of the Company in proceedings before the United States Congress, state legislatures,

federal and state regulatory agencies and the courts. The Company cannot accurately predict the financial and operating impacts which may result from revisions to existing laws.

Energy Sources

General

As the table below indicates, the Company has used natural gas and coal almost exclusively since 1981. However, the percent of purchased power in the Company's energy mix has increased steadily since 1981 and in 1985 comprised over 60% of the Company's energy requirements. Nuclear fuel will begin to comprise a portion of the Company's fuel mix in 1986. The following table lists the percentage contribution of coal, gas, oil and purchased power to the total energy mix of the Company and the average cost to the Company in cents per KWH.

	Coal		Gas		Oil		Purchased Power	
	Percent of Energy Mix	Average Cost	Percent of Energy Mix	Average Cost	Percent of Energy Mix	Average Cost	Percent of Energy Mix	Average Cost
1981	14%	.65¢	82%	3.18¢	1%	5.54¢	3%	1.85¢
1982	15	.70	59	4.00	1	6.94	25	2.80
1983	18	.77	42	4.23	3	4.38	37	2.30
1984	16	.83	46	4.00	1	12.19	37	2.64
1985	10	1.02	28	3.81	1	8.21	61	2.80

During the year ended December 31, 1985, the Company's average cost of coal was $17.75 per ton and of natural gas $3.48 per MCF. For a discussion of the recovery by the Company of its fuel costs, either in base rates or through fuel adjustment clauses, see "Rates and Regulation."

The Company's El Paso generating units are subject to the requirements of the Fuel Use Act. Under such Act, the Company may continue to burn natural gas in its existing generating units for the life of the units subject to compliance with a DOE approved energy conservation plan filed by the Company with the DOE in 1982. The Company is required to file annual compliance reports outlining the steps which were taken in the previous year to implement the conservation plan. Upon the fifth year of implementation (1987), the Company is required to demonstrate that it has attained conservation of electrical energy, as measured annually, in the amount of ten percent of the net system energy which was attributed to natural gas during the year ending June 30, 1981. This requirement is expected to be realized within the allowed five year implementation period of the Company's conservation plan, which calls for continuing programs in the areas of customer assistance, public information and operating efficiency.

During 1985 the Company continued to reduce its natural gas and fuel oil requirements through purchases of economy energy which were available in large amounts as a result of various factors. It is expected that this trend will continue to offset the Company's natural gas and fuel oil requirements through 1986.

On January 1, 1985, under the provisions of the 1978 Natural Gas Policy Act, Federal maximum price restrictions on between 40 and 60 percent of all natural gas (intrastate and interstate) were removed. The impact on the Company was minimal because the high availability of natural gas and competition from fuel oil and the gas industry itself have contributed to keeping natural gas prices stable. In 1985, the FERC initiated a revolutionary new program under FERC Order 436. Under this order, a gas pipeline company that chooses to transport natural gas must do so on a non-discriminatory basis. As of yet, the Company's supplier of interstate gas (which is under FERC jurisdiction) has not chosen to participate in the FERC program. The supplier has indicated that it may begin participation in the program in 1986. The supplier's uncertain participation in the program makes it difficult to assess the impact on the Company's fuel costs. In addition, proposals providing complete decontrol of all natural gas supplies and increasing the regulated price of old gas to market levels are expected to be considered by Congress in 1986. However, in light of the Company's projected diminishing dependency on natural gas as well as the relationship which the depressed oil market will have on

deregulated supplies, it is expected that any changes in the current regulatory framework will have a minimal impact on the overall cost of operation.

Natural Gas

The Company is currently supplied with natural gas from both interstate and intrastate pipeline systems. The intrastate natural gas is supplied pursuant to a five-year contract which the Company entered into in December 1984. The interstate natural gas is supplied pursuant to a contract with El Paso Natural Gas Company which expires in 1987.

All of the natural gas requirements of Rio Grande are being provided pursuant to the interstate contract. Throughout 1985 El Paso Natural Gas experienced an overabundance of natural gas supplies and as a result was able to satisfy the Company's requirements at Rio Grande. This availability of natural gas supplies is expected to continue through 1986.

The intrastate natural gas requirements at Copper and Newman are supplied pursuant to the intrastate contract. In addition, interstate natural gas can be supplied to Newman Units 1, 2 and 3. This allows for a backup natural gas supply, which offsets the need for fuel oil during periods when operational constraints on the intrastate gas system dictate the need for an alternate fuel supply. During 1985, the Company experienced no significant supply curtailments at either Copper or Newman and does not expect any significant curtailment during 1986 with respect to either interstate or intrastate supplies.

Fuel Oil

In May 1984, the Company's fuel oil supply contract with an independent trust was extended for an additional five-year period to expire in June 1989. Under this arrangement, the trust sells fuel oil to the Company upon request at a price equal to the trust's costs related thereto. The trust acquires the fuel oil in the open market. The Company has agreed to purchase all of the fuel oil owned by the trust at or prior to the termination of the five-year agreement. Simultaneously with the five-year extension of the fuel supply contract between the Company and the trust, the trust entered into a new credit agreement providing for a $15 million five-year revolving credit loan, bearing interest at a variable interest rate based upon, at the option of the Company, either a CD, LIBOR or prime rate. The Company is authorized from time to time to borrow from the trust on a short-term basis (and the trust in such event is required to borrow from the lenders) up to $7 million, provided that no portion of such borrowed amounts is required by the trust to purchase fuel oil.

Coal

The Company believes that sufficient reserves of low sulfur coal (the sulfur content of which is currently running 0.7%) have been committed to the two units of Four Corners in which the Company has an undivided interest so as to continue operating such units for their useful lives. Prices paid for coal supplied from reserves dedicated under existing contracts have been escalating pursuant to applicable contract clauses. In addition, major price increases from time to time result from contract renegotiation.

In connection with the 1985 amendment to the Four Corners coal site lease agreement, the coal supplier to the Four Corners Plant and the Four Corners participants negotiated agreements with the Navajo Tribe to increase royalty payments to the Tribe in return for certain contractual and other concessions. The Company believes, but has no assurance, that any increased costs incurred as a result of such increased royalties will be recoverable either through fuel adjustment clauses or as a recovery of operating expenses in subsequent rate proceedings. See "Facilities — Four Corners Litigation."

Nuclear Fuel

The fuel cycle for the Palo Verde Station is comprised of the following stages: (1) the mining and milling of uranium ore to produce uranium concentrates; (2) the conversion of uranium concentrates to uranium hexafluoride; (3) the enrichment of uranium hexafluoride; (4) the fabrication of fuel assemblies; (5) the utilization of fuel assemblies in reactors; and (6) the storage of spent fuel and the disposal or (if future circumstances permit) the reprocessing thereof. Arrangements have been made

to insure that Palo Verde's requirements of materials and services for each stage of the fuel cycle will be available as needed over an extended period.

Uranium concentrates in inventory and available under contracts with Energy Fuels Exploration Company, Pathfinder Mines Corporation and other sources should meet Palo Verde's operational requirements through 1998 and beyond that year if options to purchase uranium concentrates under the fabrication contract with Westinghouse Electric Corporation (discussed below) are exercised. Options provided under the above contracts will permit the purchase of a portion of Palo Verde's uranium concentrate requirements on the spot market without penalty if the spot market purchase becomes economical. Uranium hexafluoride in storage and to be obtained through 1992 under a conversion service contract with Allied Corporation will meet Palo Verde's operational requirements for uranium hexafluoride through 1992. Existing contracts for fabrication services with Combustion Engineering, Inc. and Westinghouse Electric Corporation will provide fuel assembly and services for each of the Palo Verde units for at least the first two years of operation and approximately the next fifteen years of operation of each unit, respectively.

The participants in Palo Verde, including the Company, have enrichment services contracts with DOE that obligate DOE to furnish the enrichment services required throughout the life of each of the Palo Verde units. In September 1985, the United States District Court for the District of Colorado held that the form of utility services contract used by DOE in negotiations with utilities, including the Palo Verde participants, is null and void. DOE has appealed the decision and has publicly announced that pending the final resolution of the appeal, it will continue to treat the enrichment services contracts, including the Palo Verde contract, as valid and perform its obligations under the contracts.

Pursuant to the Nuclear Waste Policy Act of 1982 (the "Nuclear Waste Act"), DOE is obligated to accept and dispose of all spent nuclear fuel and other high-level radioactive wastes generated by all domestic power reactors, and all operators of nuclear power reactors have been required to enter into spent fuel disposal contracts with DOE. The Project Manager, on behalf of itself and the other Palo Verde participants, including the Company, has executed a spent fuel disposal contract with DOE. The Nuclear Waste Act also obligates DOE to develop the facilities necessary for the disposal of all spent fuel generated and to be generated by domestic power reactors and to have the first such facility in operation by 1998 under prescribed procedures. Such development process is currently in progress. Spent fuel storage facilities at Palo Verde have sufficient capacity to store all fuel expected to be discharged from normal operation of all Palo Verde Units during a period extending beyond the year 2000.

Under the Participation Agreement among the participants in the Palo Verde Station, the Company has an undivided interest in nuclear fuel purchased and to be purchased in connection with the operation of Units 1, 2 and 3 of the Station. The Company has a nuclear fuel purchase commitment with an independent trust. The trust's financing is based upon a letter of credit with a three-year term which is annually extended by one year if notice to the contrary is not given to the trust by the issuing bank. The letter of credit is currently scheduled to expire on January 8, 1989, but it will be automatically extended to January 8, 1990 if the issuing bank does not notify the trust otherwise by the required date in 1986. The trust purchases nuclear fuel and incurs all costs in connection with the acquisition of the fuel and related materials for use by the Company at Palo Verde. The Company has the option of either purchasing the fuel from the trust or leasing the heat generated by the fuel at prices established to reimburse the trust for all the costs incurred in connection with acquisition of the fuel. The Company is required to elect one of these options for each batch of nuclear fuel. The Company has elected the lease option as the basis for payment for the first fuel loads for Palo Verde Units 1 and 2, and presently intends to elect the lease option as the basis for payment for future fuel loadings. Quarterly lease payments at the established prices began in the first quarter of 1986 for Palo Verde Station Unit 1 and will begin for Unit 2 when it is placed into commercial operation, which is expected to occur in the third quarter of 1986. At December 31, 1985, the aggregate investment of the trust in such nuclear fuel and related materials was approximately $92,900,000, including leased amounts of approximately $52,600,000 for fuel loaded at Palo Verde Units 1 and 2.

Executive Officers of Registrant

Name	Age	Current Position and Business Experience
Evern R. Wall	53	Chairman of the Board since December 1980; President and Chief Executive Officer since May 1976; and Member of the Executive Committee of the Board of Directors.
Billye E. Bostic	55	Executive Vice President since May 1982; Senior Vice President from December 1978 to May 1982.
Charles Mais	54	Vice President since December 1978.
Ignacio R. Troncoso	39	Vice President since May 1982 and for more than 5 years prior thereto served in various managerial and supervisory capacities in the Company's engineering department.
Lawrence M. Downum, Jr.	47	Vice President since December 1983 and for more than five years prior thereto served in various managerial and supervisory capacities with the Company.
William J. Johnson	44	Vice President since May 1984 and Controller since May 1978.
William W. Royer	41	Vice President since December 1985, Treasurer since December 1983 and General Counsel since March 1981.
Joseph E. Wasiak	54	Vice President since February 1986; Assistant Vice President since May 1984 and for more than 5 years prior thereto served in various managerial and supervisory capacities with the Company.
James P. Maloney	54	Vice President since February 1986; Assistant to the President since October 1985; Commanding General of Fort Bliss, Texas from June 1982 to August 1985 and on the Department of the Army Staff—The Pentagon from February 1977 to June 1982.
Theta S. Fields	60	Secretary since 1977.

The executive officers of the Company are elected no less often than annually and serve at the discretion of the Board of Directors.

Subsidiary's Investments

The Subsidiary, a wholly-owned, non-utility subsidiary of the Company, borrows independently from third parties, without recourse to the Company (except for certain borrowings pursuant to the Company's nuclear fuel and fuel oil financing arrangements) for the purposes of its various investments and activities. The Subsidiary's major projects include the restoration and development of the Westin Paso Del Norte Hotel and the Cortez Hotel in downtown El Paso, both of which it purchased in 1982. Simultaneously with such purchases, the Subsidiary entered into long-term leases as the lessee of the land underneath each hotel.

The Cortez Hotel has been rehabilitated, at an aggregate cost of approximately $13,600,000 for acquisition and improvements, as the Cortez Office Building (with approximately 91,000 rentable square feet), which was placed in service in May 1985 and was approximately 65% leased at December 31, 1985. The Subsidiary intends to form a limited partnership for the ownership and operation of this building, with the Subsidiary serving as general partner and receiving a fifty percent share of the partnership's gains and losses, subject to certain special allocations among the partners. The Subsidiary has also purchased land adjacent to the Cortez Office Building and has constructed a seven-story parking garage thereon, the ground floor of which is occupied by a major savings bank.

The Subsidiary acquired additional land adjacent to the Westin Paso Del Norte Hotel and is constructing thereon an underground parking garage and an additional hotel tower. The aggregate cost of the acquisition of the Westin Paso Del Norte Hotel improvements, renovation thereof and acquisition and construction of the additional land, parking facilities and additional hotel tower is projected to be approximately $60,000,000, of which approximately $37,000,000 has been expended at December 31, 1985. The Subsidiary contemplates forming a limited partnership, similar to the one described in the preceding paragraph, for the operation and ownership of the Westin Paso Del Norte Hotel after its opening. Westin Hotel Company has entered into an agreement to manage the hotel. The Westin Paso Del Norte will, upon completion, consist of 380 rooms, two restaurants and a lounge, and banquet facilities for 1300 people, all in a modern hotel facility.

Substantially all of the funds required for acquisition and development of the Cortez and the Westin Paso Del Norte projects have been borrowed on a long-term basis from various sources, with the borrowings secured by all assets related to the two projects and by certain investment securities held by the Subsidiary. (See Note "G" of Notes to Consolidated Financial Statements.) The Subsidiary has also invested in certain partnerships for the leasing of assets (such as data processing equipment) to third parties, preferred stocks, and real estate, primarily located in downtown El Paso.

Review by Counsel

Statements as to matters of law and legal conclusions under the subcaptions "Rates and Regulation"; "Facilities — Copper Power Station"; "Facilities — Four Corners Project"; and "Energy Sources — General", all such subcaptions being included under "Business" in Item 1 of this report, have been prepared or reviewed by Kemp, Smith, Duncan & Hammond, a professional corporation, El Paso, Texas. Statements as to matters of law and legal conclusions involving litigation with the Navajo Indian Tribe and contained under "Facilities — Four Corners Litigation" (except as to matters relating to the adjudication of water rights of the San Juan River Stream System in New Mexico), statements as to matters of law and legal conclusions contained in the second, third and fourth paragraphs under "Facilities — Palo Verde Litigation"; statements as to matters of law and legal conclusions contained in "Facilities — Palo Verde Liability and Insurance Matters"; statements as to matters of law and legal conclusions involving the Four Corners Project and contained under "Environmental Matters"; and statements as to matters of law and legal conclusions contained in the fourth paragraph under "Energy Sources — Nuclear Fuel," all such subcaptions being included under "Business" in Item 1 of this report, have been prepared or reviewed by Snell & Wilmer, Phoenix, Arizona. Such statements have been included herein upon the authority of said respective counsel as experts.

Operating Statistics

	December 31,		
	1985	1984	1983
Operating revenues (In thousands):			
Residential	$ 108,289	$ 106,052	$ 99,112
Commercial and industrial, small	104,679	102,226	96,041
Commercial and industrial, large	45,325	48,619	43,805
Sales to public authorities	53,993	55,149	52,817
Sales for resale	24,981	15,780	9,571
Other	2,324	1,189	1,097
Total operating revenues	$ 339,591	$ 329,015	$ 302,443
Number of customers (End of year):			
Residential	191,248	185,062	177,810
Commercial and industrial, small	19,349	18,650	17,840
Commercial and industrial, large	41	40	41
Other	2,263	2,151	2,109
Total	212,901	205,903	197,800
Average annual use and revenue per residential customer:			
KWH	5,735	5,755	5,839
Revenue	$ 575.37	$ 582.94	$ 568.76
Average revenue per KWH:			
Residential	10.03¢	10.13¢	9.74¢
Commercial and industrial, small	8.70	8.89	8.72
Commercial and industrial, large	6.51	6.56	6.47
Energy supply, net, KWH (In thousands):			
Generated	1,823,946	2,705,213	2,532,721
Purchased and interchanged(1)	2,838,904	1,643,257	1,507,166
Total	4,662,850	4,348,470	4,039,887
Energy sales, KWH (In thousands):			
Residential	1,079,432	1,046,933	1,017,565
Commercial and industrial, small	1,202,938	1,149,471	1,101,862
Commercial and industrial, large	696,662	741,134	677,118
Sales to public authorities	786,983	773,886	760,587
Sales for resale	511,517	324,354	194,639
Total sales	4,277,532	4,035,778	3,751,771
Losses and company use(2)	385,318	312,692	288,116
Total	4,662,850	4,348,470	4,039,887
Native system peak load, KW	778,000	776,000	746,000
Net generating capacity for peak, KW(3)	989,000	989,000	990,000
Load factor	68.4%	63.8%	61.8%

(1) Includes 211,199,000 KWH of test energy from Palo Verde Unit 1.

(2) This amount includes Palo Verde and Company losses.

(3) The 1985 amount excludes the net generating capacity of Palo Verde Unit 1 which was not placed in service until late December 1985 and the transfer of Rio Grande Units 3, 4 and 5 to plant held for future use.

Item 2. Properties

The principal properties of the Company are described in Item 1 of this report, and such descriptions are incorporated herein by reference thereto. Transmission lines are located either on private rights-of-way, easements, or on streets or highways by public consent. Reference is made to Note "G" of "Notes to Consolidated Financial Statements" for information regarding encumbrances against the principal properties of the Company and the Subsidiary.

Item 3. Legal Proceedings

Information regarding legal proceedings relating to Palo Verde, Four Corners, rates and regulations and environmental matters is described under the subcaptions "Rates and Regulation," "Facilities" and "Environmental Matters" under "Business" in Item 1 of this report and is incorporated herein by reference thereto.

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable.

PART II

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters

The Company's common stock is traded in the over-the-counter market and quoted on the NASDAQ National Market System. The high and low sale prices for the Company's common stock, as reported by NASDAQ, and the quarterly dividends per share paid by the Company, for the periods during 1984 and 1985 indicated below, were as follows:

	Sale Price		
	High	Low	Dividends
1984			
First Quarter	14½	10⅞	$0.35
Second Quarter	12	10	0.35
Third Quarter	12¼	10⅛	0.365
Fourth Quarter	14	11⅞	0.365
1985			
First Quarter	14⅝	12⅝	0.365
Second Quarter	15⅜	14⅛	0.365
Third Quarter	16	13⅛	0.38
Fourth Quarter	15⅞	13¼	0.38

At February 28, 1986, there were approximately 53,900 holders of record of the Company's common stock.

The Company's Restated Articles of Incorporation and the First Mortgage Indenture and certain of the supplemental indentures relating to the various series of First Mortgage Bonds contain restrictions as to the payment of dividends on the common stock of the Company and as to the purchase or retirement of capital stock of the Company. At December 31, 1985, the amount available for dividends on the common stock under the most restrictive of those provisions was approximately $167,400,000.

The Company has paid quarterly dividends on its common stock without interruption since distribution of the common stock to the public in 1947 (38 years). The current indicated annual dividend rate is $1.52 per share. The Company intends to continue to pay quarterly dividends on its common stock, but future dividends will depend upon adequate rate relief, earnings, cash flow, the

financial condition of the Company and other factors. (See "Industry and Company Conditions" and "Construction and Financing Programs — Future Financing" in Item 1 of this report)

Item 6. Selected Financial Data

As of and for the years ended December 31:

	1985	1984	1983	1982	1981
		(In thousands except per share data)			
Operating revenues	$ 339,591	$ 329,015	$ 302,443	$ 271,048	$ 250,965
Net income	113,071	108,286	87,261	70,888	56,697
Net income per share of common stock	2.88	2.88	2.48	2.30	2.23
Dividends declared per share of common stock	1.49	1.43	1.37	1.31	1.25
Total assets	1,919,060	1,690,109	1,393,283	1,132,626	887,648
Long-term obligations and preferred stock — redemption required	971,228	803,577	591,563	463,949	314,192

See "Industry and Company Conditions," "Rates and Regulation" and "Construction and Financing Programs — Future Financing" in Item 1 of this report.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

For information in regard to industry and Company conditions and rate matters, see "Industry and Company Conditions," "Rates and Regulation" and "Construction and Financing Programs — Future Financing" in Item 1 of this report.

Liquidity and Capital Resources

The Company has been very successful in its overall construction financing program, and at December 31, 1985, had approximately $30,000,000 of cash and temporary investments available for future construction requirements. Subsequent to December 31, 1985, the Company obtained $70,000,000 in additional financing in the form of secured long-term debt. The following schedule summarizes how the Company generated funds for construction for the years 1985, 1984 and 1983:

	1985	1984	1983
		(In thousands)	
Net funds provided from financing	$136,490	$187,857	$187,311
Funds provided from operations, reinvested	47,100	50,404	44,119
Net other funds provided (used):			
Net (increase) decrease in working capital other than short-term obligations, principally cash and temporary investments	79,340	(48,257)	(35,785)
Other	6,189	(15,861)	3,580
Expenditures for utility plant and other plant	$269,119	$174,143	$199,225

The expenditures for utility plant and other plant include the borrowed portion of AFUDC in the amounts of approximately $41,691,000, $44,701,000, and $32,435,000 for the years 1985, 1984 and 1983, respectively. AFUDC does not currently generate cash.

Based upon estimated costs prepared as of March 14, 1986, the Company anticipates its construction expenditures (excluding nuclear fuel) from January 1, 1986 through December 31, 1989 as follows:

	Cash	AFUDC (Net of deferred tax)
	(In thousands)	
Palo Verde	$119,800	$62,400
Other	170,100	13,700
	$289,900	$76,100

The above estimates are reviewed and adjusted from time to time as necessary to reflect changed conditions.

Results of Operations

The primary reasons for increases (decreases) in results of operations for the year ended December 31, 1985, over the year ended December 31, 1984, and the year ended December 31, 1984, over the year ended December 31, 1983, are as follows (in thousands):

	1985 over 1984	1984 over 1983
Operating Revenues:		
Base:		
Rates and/or change in sales mix	$(3,872)	$ (571)
Volume	11,951	14,080
	8,079	13,509
Fuel:		
Recovery of fuel and purchased and interchanged power cost and other	4,468	12,502
Refunds	(3,107)	470
	1,361	12,972
Other operating revenues	1,136	91
Total	$10,576	$26,572

For 1985 over 1984, increases in KWH sales (volume) increased primarily as a result of increased sales for resale offset in part by a decrease in base rates as a result of the Texas Commission's order and a change in sales mix. For 1984 over 1983, increases in KWH sales (volume) increased base revenues.

For 1985 over 1984, fuel revenues increased as a result of recovery of increased fuel and purchased and interchanged power cost partially offset by fuel refunds. For 1984 over 1983, recovery of increased fuel and purchased and interchanged power cost resulted in increased fuel revenues.

For 1985 over 1984, other operating revenues increased due to increased wheeling revenues.

	1985 over 1984	1984 over 1983
Fuel and Purchased and Interchanged Power Expense:		
Fuel:		
Volume and average cost of fuel	$(33,684)	$ 4,665
Other	342	(342)
	(33,342)	4,323
Purchased and interchanged power:		
Volume	24,167	3,165
Cost	12,007	5,485
	36,174	8,650
Total	$ 2,832	$ 12,973

For 1985 over 1984, fuel expense decreased due to a decrease in the volume of fuel consumed, change in fuel mix and increase in fuel refunds from the Company's natural gas supplier. The increase in fuel expense in 1984 compared to 1983 was due to an increase in the volume of fuel consumed offset in part by a decrease in the average cost of fuel.

For 1985 over 1984 and 1984 over 1983, purchased and interchanged power expense increased as a result of increased purchases of lower cost electricity from other utilities and a higher average cost of electricity purchased.

Purchased and interchanged power was the Company's primary energy source during 1985 (61% in 1985, 37% in 1984 and 1983).

	1985 over 1984	1984 over 1983
Other Operations Expense:		
Wheeling	$ 1,757	$ 40
Rate case expense	1,403	(594)
Employee benefits	237	(4,815)
Other	(1,667)	4,694
Total	$ 1,730	$ (675)

Other operations expense increased in 1985 over 1984 due to increased wheeling cost associated with transmission of electricity by other utilities and increased rate case expense.

Other operations expense decreased in 1984 over 1983 due to a reduction in 1984 in the provision for employee benefit expense.

The increase in 1985 and decrease in 1984 were partially offset by certain accumulated preliminary survey and investigation charges in 1984 with no comparable expense in 1985.

	1985 over 1984	1984 over 1983
Maintenance Expense	$ 1,971	$ (3,502)

Maintenance expense increased in 1985 as compared to 1984 and decreased in 1984 as compared to 1983 due to the expensing in 1985 and 1983 of major repairs of generating units. No comparable repairs were expensed in 1984. Additionally, an insurance reimbursement in 1984 related to these costs with no comparable reimbursement in 1983 or 1985 further reduced maintenance expense in 1984 as compared to 1983 and 1985.

	1985 over 1984	1984 over 1983
Federal Income Tax Expenses:		
Operating:		
Current	$(9,315)	$ 1,088
Deferred	10,170	6,361
Charge (benefit) equivalent to investment tax credit, net of amortization	(3,322)	(3,755)
Total	$(2,467)	$ 3,694
Other income:		
Current	$ 7,066	$(2,352)
Deferred	64	1,369
Charge (benefit) equivalent to investment tax credit, net of amortization	(5,975)	2,931
Total	$ 1,155	$ 1,948
Total:		
Current	$(2,249)	$(1,264)
Deferred	10,234	7,730
Charge (benefit) equivalent to investment tax credit, net of amortization	(9,297)	(824)
Total	$(1,312)	$ 5,642

Total Federal income tax expense decreased in 1985 over 1984 primarily due to a net operating tax loss offset in part by increases in the provision for deferred taxes for capitalized Palo Verde operating and maintenance expenses, depreciation, and deferred fuel revenues.

Total Federal income tax expenses increased in 1984 over 1983 due to an increase in the provision for deferred taxes offset by a decrease in current Federal income taxes and charge equivalent to investment tax credit, net of amortization, which resulted from a decrease in taxable income.

The increased provision for deferred Federal income taxes in 1984 over 1983 was due to an increase in the provisions for deferred taxes on the borrowed portion of AFUDC and depreciation. Additionally, deferred tax credits related to employee benefits and an early retirement plan provided in 1983 and not provided in 1984 caused further increases in 1984.

	1985 over 1984	1984 over 1983
AFUDC		
Cumulative construction expenditures	$ 7,747	$25,317
Change due to CWIP included in rate base	(8,071)	(48)
Total	$ (324)	$25,269

In both 1985 and 1984, AFUDC increased over the prior year due to continued increases in cumulative construction expenditures principally associated with the Palo Verde Station. Additionally, in 1985, increases in CWIP included in rate base resulted in a net decrease in AFUDC.

AFUDC, net of deferred Federal income taxes on the borrowed portion of AFUDC, amounted to 81%, 83%, and 75% of net income applicable to common stock and net income per share during the years ended December 31, 1985, 1984 and 1983, respectively. See Note "A" of "Notes to Consolidated Financial Statements" for further information and a discussion of the non-cash nature of AFUDC.

	1985 over 1984	1984 over 1983
Interest and Net Investment Income	$ 6,317	$ 3,221

In both 1985 and 1984, interest and net investment income increased due to interest earned on the proceeds of various debt issuances invested in temporary cash investments. Additionally, during 1985, certain investments of the Subsidiary were sold at a gain.

	1985 over 1984	1984 over 1983
Interest on Long-Term Obligations	$11,983	$19,028

Interest on long-term obligations increased in 1985 over 1984 primarily due to issuance of additional first mortgage bonds in 1984, pollution control bonds, floating rate notes and nuclear fuel lease obligations. The increase in long-term interest in 1984 over 1983 is due to issuance of additional pollution control bonds, first mortgage bonds and floating rate notes.

	1985 over 1984	1984 over 1983
Other Interest Expense	$(7,352)	$ 421

Other interest expense decreased in 1985 over 1984 due to decreases in the average short-term debt rate and the average short-term debt outstanding. Other interest expense decreased during 1985 as compared to 1984 as a result of certain short-term obligations which were refunded into long-term obligations. Additionally, interest accured in 1984 on Pollution Control Bonds was reversed in 1985 as a result of a favorable ruling from the Internal Revenue Service on the tax-exempt status of such bonds.

The increase in other interest expense in 1984 over 1983 is due to an increase in the average short-term debt rate offset in part by a decrease in the average short-term debt outstanding.

	1985 over 1984	1984 over 1983
Preferred Stock Dividend Requirements	$ 1,439	$ 4,814

For 1985 over 1984, preferred stock dividend requirements increased due to the issuance of 500,000 shares of $11.375 Preferred Stock in April 1984, partially offset by the repurchase of 50,000 shares of $8.80 Preferred Stock in April 1985. For 1984 over 1983, preferred stock dividend requirements increased due to the issuance of 500,000 shares of $11.375 Preferred Stock in April 1984 and 250,000 shares of $10.125 Preferred Stock in June 1983.

Supplemental Information Concerning the Effects of Inflation

Information required with respect to the effects of inflation is included on pages 53 through 55 of this report.

Item 8. Financial Statements and Supplementary Data

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

The Shareholders and Board of Directors
El Paso Electric Company

We have examined the consolidated balance sheets of El Paso Electric Company and Subsidiary as of December 31, 1985 and 1984, and the related consolidated statements of income, retained earnings and sources of funds invested in utility plant and other plant for each of the years in the three-year period ended December 31, 1985. 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.

The cost of the Company's 15.8% interest in the Palo Verde Nuclear Generating Station (Palo Verde) aggregates $1.3 billion or 68% of consolidated assets at December 31, 1985. With the Palo Verde construction program nearly complete, the principal factor which will affect the future financial position and results of operations of the Company will be obtaining rate relief designed to ultimately recover the Company's projected increased costs of providing service and a return on investment together with the Company's financing the effects, if any, of any rate moderation plans into which it enters. See Note B of Notes to Consolidated Financial Statements.

In our opinion, the consolidated financial statements referred to above present fairly the consolidated financial position of El Paso Electric Company and Subsidiary as of December 31, 1985 and 1984, and the results of their operations and the sources of funds invested in utility plant and other plant for each of the years in the three-year period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

PEAT, MARWICK, MITCHELL & CO.

El Paso, Texas
March 14, 1986

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

ASSETS

	December 31, 1985	December 31, 1984
	(In thousands)	
Utility plant:		
Electric plant in service	$1,090,050	$ 458,813
Less accumulated depreciation and amortization	129,667	127,181
Net plant in service	960,383	331,632
Construction work in progress	669,719	1,089,562
Nuclear fuel:		
Under capital leases net of amortization of $1,962,000	51,998	—
In process	9,453	—
Held for future use, net of accumulated depreciation of $11,928,000 for 1985	2,151	397
Net utility plant	1,693,704	1,421,591
Nonutility property, at cost net of accumulated depreciation of $951,000 and $669,000, respectively	65,733	28,784
Investments	58,528	66,618
Current assets:		
Cash and temporary investments	30,229	106,214
Accounts receivable, principally trade (less allowance for doubtful accounts of $863,000 and $552,000, respectively)	36,840	32,668
Federal income taxes refundable	5,073	3,406
Inventories:		
Materials and supplies	4,830	4,957
Fuel	9,655	9,617
Prepayments	3,769	2,835
Other	2,679	5,471
Total current assets	93,075	165,168
Deferred charges and other assets	8,020	7,948
Total assets	$1,919,060	$1,690,109

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

CAPITALIZATION AND LIABILITIES

	December 31, 1985	December 31, 1984
	(In thousands)	
Capitalization:		
Common stock, no par value, 40,000,000 shares authorized. Issued and outstanding 34,743,917 and 33,697,555 shares, respectively	$ 326,033	$ 310,663
Additional paid-in-capital	475	—
Retained earnings	236,042	188,804
Common stock equity	562,550	499,467
Preferred stock, cumulative, no par value, 2,000,000 shares authorized:		
Redemption required, issued and outstanding 1,306,500 and 1,374,000 shares, respectively	130,650	137,400
Redemption not required, issued and outstanding 190,000 shares	18,873	18,873
Long-term obligations	840,578	666,177
Total capitalization	1,552,651	1,321,917
Current liabilities:		
Current maturities of long-term obligations	21,813	20,345
Pollution control bonds	—	57,478
Notes payable banks	23,490	13,000
Notes payable other	6,558	15,920
Commercial paper	8,000	—
Fuel purchase commitment	9,572	9,534
Accounts payable, principally trade	14,097	13,303
Taxes accrued	13,942	13,650
Interest accrued	16,825	17,859
Other	23,606	16,449
Total current liabilities	137,903	177,538
Deferred credits and other liabilities:		
Accumulated deferred Federal income taxes	174,068	131,418
Accumulated deferred investment tax credit	50,771	55,318
Other	3,667	3,918
Total deferred credits and other liabilities	228,506	190,654
Commitments and contingencies		
Total capitalization and liabilities	$1,919,060	$1,690,109

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

For the years ended December 31, 1985, 1984 and 1983

	1985	1984	1983
		(In thousands)	
Operating revenues	$339,591	$329,015	$302,443
Operating expenses:			
Operations:			
Fuel	51,864	85,206	80,883
Purchased and interchanged power	79,503	43,329	34,679
	131,367	128,535	115,562
Other	43,521	41,791	42,466
	174,888	170,326	158,028
Maintenance	10,205	8,234	11,736
Depreciation and amortization	14,755	12,445	11,740
Taxes:			
Federal income, current	1,503	10,818	9,730
Federal income, deferred	38,449	28,279	21,918
Charge (benefit) equivalent to investment tax credit, net of amortization	(716)	2,606	6,361
Other	17,211	17,364	16,724
	256,295	250,072	236,237
Operating income	83,296	78,943	66,206
Other income (deductions):			
Allowance for equity funds used during construction	57,349	54,663	41,660
Interest and net investment income	13,566	7,249	4,028
Other, net	(2,852)	(309)	(267)
Federal income taxes applicable to other income	(2,510)	(1,355)	593
	65,553	60,248	46,014
Income before interest charges	148,849	139,191	112,220
Interest charges (credits):			
Interest on long-term obligations	80,283	68,300	49,272
Other interest	1,914	9,266	8,845
Interest capitalized	(4,728)	(1,960)	(723)
Allowance for borrowed funds used during construction	(41,691)	(44,701)	(32,435)
	35,778	30,905	24,959
Net income	113,071	108,286	87,261
Preferred stock dividend requirements	14,754	13,315	8,501
Net income applicable to common stock	$ 98,317	$ 94,971	$ 78,760
Net income per share of common stock, (based on weighted average number of shares outstanding during the period)	$ 2.88	$ 2.88	$ 2.48
Dividends declared per share of common stock	$ 1.49	$ 1.43	$ 1.37
Weighted average number of common shares outstanding	34,161,430	33,014,649	31,765,021

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

For the years ended December 31, 1985, 1984 and 1983

	1985	1984	1983
		(In thousands)	
Retained earnings at beginning of year	$188,804	$141,244	$106,141
Add:			
Net income	113,071	108,286	87,261
	301,875	249,530	193,402
Deduct:			
Cash dividends:			
Preferred stock	14,754	13,315	8,501
Common stock	50,867	47,183	43,516
Capital stock expense	212	228	141
	65,833	60,726	52,158
Retained earnings at end of year	$236,042	$188,804	$141,244

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF SOURCES OF FUNDS INVESTED IN UTILITY PLANT AND OTHER PLANT

For the years ended December 31, 1985, 1984 and 1983

	1985	1984	1983
		(In thousands)	
Funds provided from operations:			
Net income	$113,071	$108,286	$ 87,261
Principal items not requiring current funds:			
Depreciation and amortization	14,755	12,445	11,740
Deferred Federal income taxes, net	43,306	37,996	31,748
Investment tax credit, net	(3,764)	5,533	6,356
Allowance for equity funds used during construction	(57,349)	(54,663)	(41,660)
Other	2,702	1,305	691
Funds provided from operations	112,721	110,902	96,136
Less dividends	65,621	60,498	52,017
Funds provided from operations, reinvested	47,100	50,404	44,119
Funds provided from financing:			
Sales of securities:			
Common stock	15,370	14,013	17,374
Preferred stock	—	50,000	25,000
First mortgage bonds	—	126,500	—
Pollution control obligations, net of amounts on deposit with trustee	64,025	76,768	57,515
Secured promissory notes	72,125	16,829	84,094
Unsecured promissory notes	45,000	2,425	—
Capital lease obligations	55,160	1,221	1,241
Transfer of long-term obligations to short-term obligations	(21,814)	(19,813)	(31,724)
Redemption of long-term obligations	(40,219)	(41,040)	(8,233)
Redemption of preferred stock	(6,750)	(1,000)	(400)
Increase in additional paid-in-capital	475	—	—
Net increase (decrease) in short-term obligations*	(46,882)	(38,046)	42,444
Net funds provided from financing	136,490	187,857	187,311
Other funds provided (used):			
Investments	5,321	(24,019)	(4,376)
Net (increase) decrease in working capital other than short-term obligations, principally cash and temporary investments	79,340	(48,257)	(35,785)
Exchange of property	1,112	8,545	—
Net change in deferred accounts	(441)	(1,120)	5,608
Other, net	197	733	2,348
Net other funds used	85,529	(64,118)	(32,205)
Expenditures for utility plant and other plant	269,119	174,143	199,225
Allowance for equity funds used during construction	57,349	54,663	41,660
Funds invested in utility plant and other plant	$326,468	$228,806	$240,885

* Short-term obligations are represented by the current portion of long-term obligations, pollution control bonds, notes payable banks, notes payable other and commercial paper.

See accompanying notes to 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 FERC. The Subsidiary is not a regulated company.

The Company reports under the guidelines of Statement of Financial Accounting Standards ("SFAS") No. 71, Accounting for the Effects of Certain Types of Regulation. This pronouncement provides for specialized reporting and accounting requirements as they relate to specific transactions which are unique to the industry. In December 1985, the Financial Accounting Standards Board issued an exposure draft that would, if enacted in its present form, significantly change generally accepted accounting principles for regulated enterprises. The exposure draft proposes revised accounting requirements for phase-in (rate moderation) approaches to cost recovery of completed plant construction, disallowance of recovery of all or a portion of completed plant construction due to imprudency or excess capacity, and disallowance of recovery of costs associated with abandoned plants.

If the exposure draft is adopted in its present form, any rate moderation plan entered into by the Company would be subject to the provisions of this amendment and would require full recovery of costs deferred under the plan within ten years of commencement of such deferrals. Also, the amendment would require that any disallowed costs associated with a newly completed generating facility, or an abandoned facility, be charged to expense at the time such disallowances are determined to be probable. See Note B of Notes to Consolidated Financial Statements.

Principles of Consolidation

The consolidated financial statements include the Company and Subsidiary. All intercompany balances and significant intercompany transactions have been eliminated in consolidation.

Utility Plant

Utility plant is 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 cost of depreciable utility plant retired or sold and the cost of removal, less salvage, are charged to accumulated depreciation.

AFUDC

The applicable regulatory authorities provide for the capitalizing of 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 an increase in utility plant under construction for rate making purposes with a corresponding credit to income, it is not current cash income. AFUDC, net of certain tax effects, is normally recovered in cash over the service life of utility plant in the form of increased revenue collected as a result of higher depreciation expense. See Note B of Notes to Consolidated Financial Statements.

The amount of AFUDC is determined by applying an accrual rate to the balance of certain CWIP. In this connection, the FERC has promulgated procedures for the computation (a prescribed formula) of the accrual rate. The Company also compounds AFUDC on major construction projects semiannually.

Investments

Investments are stated at cost which approximates market.

Operating Revenues

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

Fuel Cost Adjustment Provisions

The Company's Texas retail customers are presently being billed under a fixed fuel factor approved by the Texas Commission in connection with the Commission's order in the Company's 1985 rate filing. This fuel factor will remain in effect until the earlier of the Company's next general rate case or Commission ordered fuel reconciliation. On February 21, 1986 the Texas Commission passed a new fuel rule which would subject the utility's fixed fuel factor to a monthly reduction, as opposed to an annual reduction, if the utility had materially overrecovered its allowable fuel costs under its existing fuel factor.

Rate tariffs currently applicable to FERC and New Mexico jurisdictional customers contain appropriate fuel and purchased power cost adjustment provisions designed to recover the Company's fuel costs. Effective March 1986 the New Mexico tariffs will contain a fixed factor similar to Texas.

Unamortized Debt Expense and Premium or 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 methods of computing depreciation of utility plant are used for Federal income tax reporting purposes which differ from the methods used for financial reporting purposes. Differences in the tax and financial methods of accounting for tax leases and other investments, nuclear fuel interest, fuel revenues and other capitalized costs also exist. In accordance with regulatory authority requirements and accounting requirements related to non-regulated companies, provision has been made in the financial statements for Federal income taxes deferred to future years as a result of these items. In addition, deferred Federal income taxes are provided on the borrowed portion of AFUDC.

Investment tax credit utilized is deferred and amortized to income over the estimated useful lives of the related properties after such properties are placed in service.

Reclassification

Certain amounts in the consolidated financial statements for 1984 and 1983 have been reclassified to conform with the 1985 presentation.

B. Regulatory Matters and Financing Requirements

The cost of the Company's 15.8% interest in Palo Verde aggregates $1.3 billion or 68% of total consolidated assets at December 31, 1985. With construction of Palo Verde Units 1 and 2 complete and Unit 3 nearly complete, the principal factor which will affect the future financial position and results of operations of the Company will be obtaining rate relief designed to ultimately recover the Company's projected increased costs of providing service and a return on investment together with the Company's financing the effects, if any, of any rate moderation plans into which it enters. Management

believes, based upon existing law and pertinent facts and circumstances, that the Company is entitled to rate relief to recover its costs of providing service plus a return on investment and that such rate relief will be obtainable, although such rate relief cannot be predicted with certainty.

The Texas Commission previously approved the Company's 15.8% participation in the Palo Verde Station and issued a certificate of convenience and necessity allowing the Company to proceed with construction. Consistent with its approval of the Company's participation in the project, the Texas Commission has granted the Company rate relief in varying amounts and has consistently allowed at least 50% of Palo Verde test-year CWIP in rate base during the construction period. Even though the Commission has ordered a reduction in rates in the Company's 1984 and 1986 rate orders, it continued the allowance of test-year CWIP in rate base and granted the Company a return on common equity of 16.4% and 15.0% in the respective orders. In each case, the allowed rate of return reflected the Commission's finding as to the current cost of equity. However, the Company believes that the Commission erred in substantially all of its findings and rulings and therefore has appealed both orders to the state courts. See Part I, Item 1 — "Rates and Regulation — Rate Matters — Texas — 1984 Rate Case" and "1985 Rate Case" included elsewhere herein for a discussion of the 1984 and 1986 rate orders of the Texas Commission, including the status of the Company's appeals.

The 1984 and 1986 rate orders will adversely affect the Company's cash flow and, based upon the Company's projections, will require the Company to finance a portion of its common stock dividends in 1986. Additionally, without considering the effects of a possible sale-leaseback transaction discussed herein, the Company projects that it will need rate relief in 1987 in order to generate positive cash flow from operations.

When a large power plant construction project is completed, increases in base rates generally are necessary to recover the costs of providing service and a return on investment. At December 31, 1985, Palo Verde Unit 1 was placed in commercial operation by the Company. Unit 2 was 100% complete (with fuel having been loaded) and Unit 3 was 99% complete. Inclusion in rate base, under traditional rate-making, of all three Palo Verde units over time would cause the Company's revenue requirements to increase significantly, but the base rate increases necessary would be partially mitigated by the amount of CWIP currently in rate base and by the lower cost of nuclear fuel.

Although management is pursuing a number of alternatives designed to obtain recovery of all of its Palo Verde costs, it believes that viable rate moderation plans are in the best interest of the Company's shareholders and customers, and are the most likely form of rate relief to occur in the near future. In management's opinion, the key objective of a viable rate moderation plan is to enable the Company to maintain the traditional utility pricing objective of rate continuity in an effort to avoid possible adverse effects on the Company's load growth, while providing a level of cash rate relief that is adequate to meet the Company's needs. Additionally, in order for a rate moderation plan to be successful, the Company believes that the plan must contain a regulatory order to defer, for future recovery, any costs which would not be currently recovered under the plan. The absence of such a provision would have a material adverse effect on the Company's future financial position and results of operations. For information regarding the effect of a proposed amendment to SFAS No. 71 related to rate moderation plans, see Note A. See Part I, Item 1 — "Rates and Regulation — Rate Matters — Rate Moderation" included elsewhere herein.

Consistent with its pursuit of a rate moderation plan, and to enhance the financial integrity of the Company, the Company is actively pursuing a possible sale and leaseback of Palo Verde Unit 2 and related common facilities. The result of the sale and leaseback, if consummated, would be to reduce the Company's cost of capital and thereby achieve a form of rate moderation. Although there can be no assurance that such a sale and leaseback transaction will be consummated, the proceeds to the Company from such a transaction with respect to all of the Company's undivided ownership interest in Unit 2, or a substantial portion thereof, would satisfy a substantial portion of the Company's external

financing requirements for 1986 through 1989. Because such a transaction would be designed to reduce the Company's annual cost of capital, and, therefore, its need for rate relief, the Company believes that such a transaction if consummated, would have a positive effect on the Company's cash flow, mitigating, if necessary, the effects of any future failure to obtain rate relief.

In addition to considering rate moderation proposals, the Company intends to file during 1986 for a rate increase seeking inclusion in rate base of the full cost applicable to the Company's share of Palo Verde Unit 1 and common plant and a sufficient amount of CWIP on Palo Verde Units 2 and 3 to protect the financial integrity of the Company. See Part I, Item 1 — "Rates and Regulation — Rate Matters — Texas — 1986 Rate Case" included elsewhere herein.

In order to meet its 1986-1989 cash construction requirements (including nuclear fuel acquisition payments), mandatory preferred stock redemptions, long-term debt maturities and dividends, the Company presently estimates that approximately $883 million cash will be required. The Company intends to meet this cash requirement through a combination of external financings and internally generated funds, which management believes will be provided through rate relief (including rate moderation plans). On February 11, 1986, the Company completed $70 million of this financing by means of a five-year, secured bank loan. As previously discussed, the Company is pursuing a sale and leaseback transaction with respect to a portion of its undivided ownership interest in Palo Verde Unit 2 and related common facilities, which, if consummated, would satisfy a substantial portion of the Company's cash requirements for the 1986-89 period.

Although management believes that the Company will be able to obtain the necessary external financing during the 1986-1989 time period, the cost to the Company of such financing may be substantially increased over what it otherwise would be without adequate and timely rate relief during that time period. The terms of such external financing may also be affected by other factors, including market conditions, the credit ratings of the Company's securities, and any regulatory orders relating to rate moderation plans. The extent of external financing by the Company is also subject to the restrictions in the Company's Restated Articles of Incorporation and First and Second Mortgage Indentures, which restrictions, to date, have not adversely affected the Company's ability to finance.

Without rate relief in 1987 and appropriate rate treatment in the case of a rate moderation plan, the earnings and interest coverage tests required by the Company's Restated Articles of Incorporation and First and Second Mortgage Indentures will be adversely affected. In such event, the Company might have to consider the curtailment of its construction program, the disposition of all or a part of its interest in the Palo Verde Station, the elimination or reduction of other operating expenses, which could ultimately have an adverse effect upon customer service, and the re-evaluation of dividends on common stock. Whether, and to what extent, a disposition of the Company's interest in the Palo Verde station could be effected is uncertain and, if effected, whether and to what extent such disposition or any resulting impairment of service would have a material adverse effect on the Company would depend upon the circumstances of the particular situation, including the degree and duration of, and the public and regulatory reaction to, the impairment of service.

In 1984, the utility regulatory authorities of Texas, New Mexico, Arizona and California agreed to conduct an independent audit of Palo Verde management and construction costs and a power distribution study of the Project. The purpose of the audit is to examine construction costs incurred in connection with the Palo Verde Project and to make a recommendation as to whether or not, in the opinion of the outside consulting firm, such costs have been prudently incurred and qualify for inclusion in the respective rate bases of the investor-owned participants. The power distribution study will focus upon power exchanges and other options for distributing any short-term excess power generated at Palo Verde. On November 27, 1985, the utility regulatory authorities released a first phase report prepared by the outside consulting firm in connection with the audit. The report identifies certain areas recommended for further study, including startup costs and schedule, construction and

engineering costs, system planning and project management. The report estimates that the "direct construction costs" of Palo Verde will total approximately $5.9 billion, of which approximately $3.1 billion will be subject to further study. In addition, the report recommends a review of the AFUDC costs associated with Palo Verde, as well as other certain indirect costs. The report does not express an opinion regarding the reasonableness of specific actions related to Palo Verde. Rather, it is intended to define subsequent detailed studies which may include recommendations regarding the reasonableness of such actions. The issue of the reasonableness of specific actions related to Palo Verde may relate to whether the Company may recover Palo Verde's costs from the Company's customers. The next phase of the audit began in March 1986, with recommendations expected in late 1986 or 1987.

Although the Company believes that the construction costs incurred and to be incurred by it in connection with its participation in the Palo Verde Project have been and will be prudently incurred, and it is necessary that such construction costs be included in rate base as CWIP or plant in service in order to provide for full recovery of costs incurred, there can be no assurance that the Texas Commission and/or the New Mexico Commission will not, either in response to the recommendations of the above discussed Palo Verde management and construction audit or irrespective of such recommendations, order a disallowance of a portion of such costs based upon a finding by the Commission of imprudency. Should either the Texas Commission or the New Mexico Commission order a disallowance of a material portion of construction costs, based upon a finding of imprudency or excess capacity, the Company would vigorously contest such an order by court action. For information regarding the effect of a proposed amendment to SFAS No. 71 on a partial disallowance of a newly completed generating facility, see Note A.

C. Palo Verde and Other Jointly Owned Utility Plant

The Company has a 15.8% undivided interest in Units 1, 2, 3 and common facilities of the Palo Verde Station near Phoenix, Arizona. Unit 1 and common facilities, having an aggregate cost of $631,673,000, were placed in service by the Company in December 1985. (See Part I, Item 1 "Rates and Regulation — Rate Matters — Texas — 1986 Rate Case" included elsewhere herein.) Construction and testing continues on the remaining units. The Company also has an interest in transmission and switchyard facilities under construction which are related to the Palo Verde Station. A portion of such transmission and switchyard facilities were placed in service in December 1984. The amount of the Company's interest which was in service and the amount that was in construction work in progress, excluding nuclear fuel, at December 31, 1985 was $650,055,000 and $654,283,000, respectively. See Note B of Notes to Consolidated Financial Statements. The participants in Palo Verde, as well as in the Company's other jointly owned facilities, are responsible for obtaining their own respective financing.

The Company is required to plan and fund, over the service life of Palo Verde, its share of the estimated costs to decommission Palo Verde. The Company has assessed the requirements for the funding of such decommissioning and found, based upon an independent study, that the Company will have to fund approximately $15,800,000 (stated in 1983 dollars) for decommissioning of Palo Verde Unit 1.

The Company does not yet have an approved plan for the funding of the decommissioning costs and final determination of the method of funding and the actual amount of funding required is dependent upon regulatory approval. The Company believes that all costs associated with nuclear plant decommissioning will be recoverable through future rates. The Company is currently funding its share of spent fuel costs associated with Palo Verde through payments to the operating agent of Palo Verde at amounts prescribed by the DOE. The Company believes that such costs will be recoverable through future rates.

See Part I, Item 1 "Facilities — Palo Verde Liability and Insurance Matters" included elsewhere herein in regard to the Company's nuclear insurance coverage.

D. Depreciation and Amortization of Utility Plant

Total provision for utility plant depreciation was $14,797,000 in 1985, $12,276,000 in 1984 and $11,506,000 in 1983, of which $513,000, $419,000 and $354,000, respectively, was applicable to transportation equipment and has been charged to other accounts. The 1985 provision for utility plant depreciation does not include any depreciation related to Palo Verde Unit 1 and common facilities inasmuch as such facilities were not placed in service until late December 1985. See Part I, Item 1 "Rates and Regulation — Rate Matters — Texas — 1986 Rate Case" included elsewhere herein.

The Company is amortizing nuclear fuel under the units of heat production method. During 1985, $1,962,000 was capitalized to CWIP.

The average annual depreciation rate used for utility plant by the Company during 1985, 1984 and 1983 was 3.28%.

E. Common Stock

Employee Stock Purchase Plan

The Company has an employee stock purchase plan under which eligible employees are granted options twice each year to purchase, through payroll deductions, shares of common stock from the Company at a specified discount from the fair market value of the stock; provided, however, if the option price exceeds the fair market value of the stock on the date of exercise of the option, the Company, in lieu of selling the stock at the option price, purchases in the over-the-counter market, for the accounts of the participants, that number of shares of common stock as the aggregate of the payroll deductions under the plan will purchase. During 1985, 1984 and 1983, common stock totaling 11,150, 9,253 and 14,178 shares, respectively, were purchased pursuant to the plan for $140,000, $87,000 and $165,000, respectively. The corresponding fair market values as of the option exercise dates were $171,000, $95,000 and $183,000, respectively. At December 31, 1985, shares reserved for issuance under the plan were 189,584.

Dividend Reinvestment and Stock Purchase Plan

The Company has a dividend reinvestment and stock purchase plan under which holders of record of common stock may purchase from the Company at fair market value shares of common stock by reinvesting cash dividends and/or making optional cash payments of up to $3,000 per calendar quarter. During 1985, 1984 and 1983, shareholders purchased from the Company 921,463, 1,110,840 and 861,173 shares, respectively, for $13,544,000, $13,010,000 and $12,206,000, respectively. At December 31, 1985, shares reserved for issuance under the plan were 1,197,921. The provision of the Internal Revenue Code which allowed the first $750 ($1,500 on a joint Federal income tax return) of dividends received on common stock of public utilities to be exempt from tax if such dividends were reinvested in common stock of the public utility expired December 31, 1985.

Employee Stock Ownership Plan and Trust

The Company has a qualified employee stock ownership plan under which common stock with a fair market value (as defined) equal to the sum of a specified amount of the Company's investment tax credit (based on payroll costs) is contributed by the Company to the plan. Effective through the Company's tax year ended December 31, 1982, the Company's investment tax credit for purposes of Company contributions to the plan was based on investment in property and employee cash participation was permitted by the plan. In compliance with the provisions of the Economic Recovery

Tax Act of 1981, the Company's plan was amended effective January 1, 1983, to eliminate the employee cash participation in the plan. In October 1985, 1984 and 1983, the Company and participating employees contributed 8,032 (Company only), 11,172 (Company only) and 249,760 shares of common stock to the plan, with respect to the 1984, 1983 and 1982 tax years, respectively, with market values of $111,000, $130,000 and $3,664,000, respectively. At December 31, 1985, shares reserved for future contributions by the Company to the plan were 231,820.

Customer Stock Purchase Plan

The Company has a customer stock purchase plan under which shares of Company common stock may be purchased from the Company at fair market value by its Texas and New Mexico customers. Customers may purchase shares by making cash payments in amounts of not less than $25 per payment nor more than $3,000 total investment per calendar quarter. Dividends paid on all shares purchased by a participant are automatically reinvested in additional shares, except for those participants who request in writing the stock certificates and cash dividends. During 1985, 1984 and 1983, common stock totaling 44,354, 66,873 and 91,924 shares, respectively, were purchased by customers of the Company in the amounts of $651,000, $786,000 and $1,339,000, respectively. At December 31, 1985, shares reserved for issuance under the plan were 647,405.

Employee Stock Compensation Plan

In January, 1985, the Company established the Employee Stock Compensation Plan under which shares of Company common stock are being offered to eligible employees. Under the Plan, the Board's Compensation Committee may direct the issuance from time to time of Company common stock to compensate employees for past services rendered to the Company or to pay for various employee benefits with common stock rather than with cash. During 1985, 61,363 shares were issued in the amount of $924,000. At December 31, 1985, 238,637 shares were reserved for future contributions under the plan.

Leveraged Employee Stock Ownership Plan and Trust

In January, 1985, the Company established the Leveraged Employee Stock Ownership Plan and Trust (LESOP) to borrow money that is used to purchase Company common stock on the open market for future allocation to eligible employees. At December 31, 1985, the LESOP had purchased 881,500 shares of common stock.

Changes in Common Stock

Changes in common stock are as follows:

	Common Stock	
	Shares	Amount
		(In thousands)
Balance December 31, 1982	31,282,382	$279,276
Sales of Common Stock:		
1983	1,217,035	17,374
1984	1,198,138	14,013
1985	1,046,362	15,370
Balance December 31, 1985	34,743,917	$326,033

F. Preferred Stock

Preferred Stock, Redemption Required

Following is a summary of outstanding preferred stock, redemption required:

	December 31,				Optional Redemption Price Per Share at December 31, 1985
	1985		1984		
	Shares	Amount (In thousands)	Shares	Amount (In thousands)	
$10.75 Dividend.....	76,000	$ 7,600	80,000	$ 8,000	$105.250
$ 8.44 Dividend.....	138,000	13,800	144,000	14,400	106.330
$ 8.95 Dividend.....	142,500	14,250	150,000	15,000	106.710
$ 9.00 Dividend.....	100,000	10,000	100,000	10,000	—
$ 8.80 Dividend.....	—	—	50,000	5,000	—
$ 9.50 Dividend.....	100,000	10,000	100,000	10,000	—
$10.125 Dividend.....	250,000	25,000	250,000	25,000	110.125
$11.375 Dividend.....	500,000	50,000	500,000	50,000	111.750
	1,306,500	$130,650	1,374,000	$137,400	

The $10.75 preferred shares are entitled to the benefits of an annual sinking fund whereby on January 1 of each year the Company will redeem 4,000 shares at the sinking fund redemption price of $100 per share plus accrued dividends.

The $8.44 preferred shares are entitled to the benefits of an annual sinking fund whereby on October 1 of each year the Company will redeem 4% (and may, at its option, redeem an additional 4%) of the aggregate maximum number of shares outstanding at the sinking fund redemption price of $100 per share plus accrued dividends. The $8.44 preferred shares are redeemable at the option of the Company; however, except as set forth above, no optional redemption of the shares may be made prior to October 1, 1988 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 8.44% per annum.

The $8.95 preferred shares are entitled to the benefits of an annual sinking fund whereby on October 1 of each year the Company will redeem 5% (and may, at its option, redeem an additional 5%) of the aggregate maximum number of shares outstanding at the sinking fund redemption price of $100 per share plus accrued dividends. The $8.95 preferred shares are redeemable at the option of the Company; however, the redemption price on the shares of such series is $108.95 through September 30, 1989 if redeemed directly or indirectly as part of or in anticipation of any refunding operation.

The $9.50 preferred shares are entitled to the benefits of an annual sinking fund whereby on July 1 of each year, beginning in 1986, the Company will offer to purchase on the next succeeding October 1, out of funds legally available for the purchase or redemption of $9.50 preferred shares, not less than 20,000 shares (or the number of such shares then outstanding if less than 20,000) at a purchase price of $100 per share plus accrued dividends. The Company is required to redeem on October 1, 1990 all shares then outstanding at a redemption price equal to $100 per share plus an amount equal to accrued and unpaid dividends to and including the date of redemption. The $9.50 preferred shares are redeemable at the option of the Company on or after October 1, 1987.

The $10.125 preferred shares are entitled to the benefits of an annual sinking fund whereby on July 1 of each year, beginning in 1989, the Company will redeem 20% (and may, at its option, redeem an additional 20%) of the aggregate maximum number of shares outstanding at the sinking fund redemption price of $100 per share plus accrued dividends. The $10.125 preferred shares are

redeemable at the option of the Company; however, no optional redemption of the shares may be made prior to July 1, 1988 as a part of or in anticipation of any refunding involving the issue of indebtedness or preferred stock having an effective interest cost (calculated after giving effect, on a pro forma basis, to the Federal income tax benefits to the Company, calculated on a basis of a Federal income tax rate equal to 80 percent of the highest marginal rate of tax paid by the Company as reflected in the Federal income tax return for the latest taxable year filed by the Company) or effective dividend cost of less than 10.125% per annum.

The $11.375 preferred shares are entitled to the benefits of an annual sinking fund whereby on July 1 of each year, beginning in 1990, the Company will redeem the lesser of 20% of the aggregate maximum number of shares issued or all shares then outstanding at the sinking fund redemption price of $100 per share plus accrued dividends. The $11.375 preferred shares are redeemable at the option of the Company; however, no optional redemption of the shares may be made prior to July 1, 1989 as a part of or in anticipation of any refunding involving the issue of indebtedness or preferred stock having an effective interest cost (calculated after giving effect, on a pro forma basis, to the Federal income tax benefits to the Company, calculated on the basis of a Federal income tax rate equal to 80 percent of the highest marginal rate of tax paid by the Company as reflected in the Federal income tax return for the latest taxable year filed by the Company) or effective dividend cost of less than 11.375% per annum.

Sinking fund requirements for each of the above series are cumulative and, in the event they are not satisfied at any redemption date, the Company is restricted from paying any dividends on its common stock (other than dividends in common stock or other class of stock ranking junior to the preferred stock as to dividends or assets).

The $9.00 preferred shares have no provision for a sinking fund, are not redeemable at the option of the Company, and must be redeemed in full on October 1, 1986 at $100 per share plus accrued dividends. In the event the Company fails to provide sufficient funds for redemption, the Company is restricted from paying any dividends on its common stock (other than dividends in common stock or other class of stock ranking junior to the preferred stock as to dividends and assets).

The aggregate amounts of the above preferred stock required to be retired for each of the next five years are as follows (in thousands):

1986	$13,750
1987	3,750
1988	3,750
1989	8,750
1990	18,750

Sales, redemption and repurchases of preferred stock, redemption required were as follows:

	Shares	Amount (In thousands)
Balance at December 31, 1982	638,000	$ 63,800
Redemption of Preferred Stock, $10.75 Dividend	(4,000)	(400)
Issuance of Preferred Stock, $10.125 Dividend	250,000	25,000
Balance at December 31, 1983	884,000	88,400
Redemption of Preferred Stock, $10.75 Dividend	(4,000)	(400)
Redemption of Preferred Stock, $8.44 Dividend	(6,000)	(600)
Issuance of Preferred Stock, $11.375 Dividend	500,000	50,000
Balance at December 31, 1984	1,374,000	137,400
Redemption of Preferred Stock, $10.75 Dividend	(4,000)	(400)
Repurchase of Preferred Stock, $8.80 Dividend	(50,000)	(5,000)
Redemption of Preferred Stock, $8.44 Dividend	(6,000)	(600)
Redemption of Preferred Stock, $8.95 Dividend	(7,500)	(750)
Balance at December 31, 1985	1,306,500	$130,650

Preferred Stock, Redemption not Required

Following is a summary of preferred stock at December 31, 1985 which is not redeemable except at the option of the Company:

	Shares	Amount (In thousands)	Optional Redemption Price Per Share
$4.50 Dividend	15,000	$ 1,534	$109.00
$4.12 Dividend	15,000	1,506	103.98
$4.72 Dividend	20,000	2,001	104.00
$4.56 Dividend	40,000	4,000	100.00
$8.24 Dividend	100,000	9,832	105.46
	190,000	$18,873	

There have been no changes in preferred stock, redemption not required, during the three years ended December 31, 1985.

All preferred stock issues (redemption required and redemption not required) are entitled, in preference to common stock, to $100 per share plus accrued dividends, upon involuntary liquidation. All issues, except the $9.00 and $9.50 preferred stock issues, are entitled to an amount per share equal to the applicable optional redemption price plus accrued dividends, upon voluntary liquidation. The $9.00 and $9.50 preferred stock issues are entitled to a fixed price ($104.50 and $106.65 per share at December 31, 1985, respectively) plus accrued dividends, upon voluntary liquidation.

G. Long-Term Obligations

Outstanding long-term obligations are as follows:

	Redemption Price at December 31, 1985(1)	December 31, 1985	December 31, 1984
		(In thousands)	
First Mortgage Bonds(2):			
4¼% Series, issued 1958, due 1988	100.50%	$ 6,100	$ 6,100
4⅝% Series, issued 1962, due 1992	101.21	10,385	10,385
6¾% Series, issued 1968, due 1998	102.80	24,800	24,800
7¾% Series, issued 1971, due 2001	104.62	15,838	15,838
9% Series, issued 1974, due 2004	105.28	20,000	20,000
10½% Series, issued 1975, due 2005	107.48	15,000	15,000
8½% Series, issued 1977, due 2007	106.34	25,000	25,000
9.95% Series, issued 1979, due 2004	109.95	23,937	25,000
16.35% Series, issued 1981, due 1991	—	40,000	40,000
16.20% Series, issued 1982, due 2012	114.52	60,000	60,000
14½% Series, issued 1984, due 1989	—	25,000	25,000
14% Series, issued 1984, due 1989	—	50,000	50,000
13¼% Series, issued 1984, due 1994	—	29,500	29,500
12¾% Series, issued 1984, due 1989	—	22,000	22,000
Pollution Control Bonds(3):			
Secured by Second Mortgage Bonds(2):			
Variable rate bonds, due 2014, net of $9,958,000 and $14,737,000, respectively, on deposit with trustee(4)		53,542	48,763
Variable rate refunding bonds, due 2014, net of $4,573,000 and $4,966,000, respectively, on deposit with trustee(5)		32,527	32,134
Variable rate refunding bonds, due 2015(6)		59,235	—
Unsecured:			
Variable rate refunding bonds, due 2013, net of $5,189,000 and $4,808,000, respectively, on deposit with trustee(4)		30,616	30,997
Balance Forward		$543,480	$480,517

	December 31, 1985	December 31, 1984
	(In thousands)	
Balance Forward	$543,480	$480,517
Floating Rate Notes Secured by Second Mortgage Bonds(2)(7):		
Due 1987	75,000	75,000
Due 1988	75,000	75,000
Promissory notes:		
Secured:		
Due 1987, two notes bearing interest at 13% and 14% per annum(8)	5,623	—
Due 1988	—	13,826
Due 1989	—	970
Due 1996 ($93,000 due in 1986)(9)	37,224	—
Due 2004, two notes bearing interest at 5% per annum through December 1988 and 10% thereafter. Payable in installments through 2004 ($195,000 due in 1986)(8)	5,530	—
Unsecured(10):		
Due 1985	—	18,000
Due 1989 ($384,000 due in 1986)	1,754	2,102
Due 1990 ($266,000 due in 1986)	21,726	1,975
Due 1992	25,000	—
Obligations under capital lease:		
Turbine lease ($1,438,000 due in 1986)(11)	12,894	13,132
Nuclear fuel ($18,233,000 due 1986)(12)	52,642	—
Mortgage notes payable, interest 12.75%, 8.8125%, and 14% per annum in 1985 and 8.8125% and 14% per annum in 1984. Payable in installments through 2004 ($141,000 due in 1986)	8,215	7,821
	864,088	688,343
Current maturities of long-term obligations	(21,813)	(20,345)
Unamortized premium and discount	(1,697)	(1,821)
	$840,578	$666,177

(1) The premiums reflected in the redemption prices continue at reduced amounts in future years, finally resulting in each case in redemption at par in the final year prior to maturity.

(2) Substantially all of the Company's utility plant is subject to a lien under the Indenture of Mortgage securing the Company's First Mortgage Bonds and a lien under the Indenture of Mortgage securing the Company's Second Mortgage Bonds.

The First Mortgage Indenture securing its First Mortgage Bonds provides for sinking and improvement funds. Except as otherwise noted, the Company is required to make annual payments to the trustee equivalent to 1%, $1,180,000 at December 31, 1985 and 1984 of the greatest aggregate principal amount of such series outstanding prior to a specified date. The Company has generally satisfied the 1% requirements for such series by relinquishing the right to use a net amount of additional property for the issuance of bonds or by purchasing bonds in the open market and expects to continue this practice. With respect to the 9.95% and 13¼% series, commencing April 1985 and April 1990, respectively, the Company will be required to make annual cash payments to the trustee equivalent to 4¼% and 20%, respectively, of the greatest aggregate principal amount of such series outstanding at any one time prior to a specified date; the cash payments must be applied to redeem bonds of the 9.95% and 13¼% series at 100% of the

principal amount thereof. No sinking fund is required for the 16.20% series until July 1987. With respect to the 16.35%, 12¾%, 14½% and 14% series bonds, no sinking fund is required.

In accordance with certain provisions of the First Mortgage Indenture, payments of cash dividends on common stock are restricted to an amount equal to retained earnings accumulated after December 31, 1966, plus $4,100,000. Retained earnings in the amount of approximately $167,400,000 are unrestricted as to the payment of cash dividends at December 31, 1985.

The 14½% series of First Mortgage Bonds, due 1989, were issued as collateral security for the repayment by the Company of a $25,000,000 five-year term loan due August 1989, bearing interest at 14½% per annum. Proceeds to the Company from the loan were $24,950,000 (after discount and before deduction of expenses).

The Second Mortgage Bonds have been issued to secure the three variable rate pollution control bond issues due 2014 and 2015, as well as the two floating rate note issues due 1987 and 1988.

(3) The funds on deposit with a trustee at December 31, 1985 represent a portion of the proceeds from pollution control revenue bonds, which proceeds are to be disbursed as needed to pay the costs of acquiring, constructing, reconstructing, improving, maintaining or furnishing the pollution control facilities financed.

(4) The variable rate bonds due 2013 and 2014 are supported by a long-term irrevocable letter of credit issued by a bank. These bonds bear interest at such rate, determined annually, as will cause the bonds to have a market value which approximates, as nearly as possible, their par value. During 1985 the interest rate on the variable rate bonds, due 2014, was 8% until July 1, 1985 and 5.5% thereafter. With respect to the variable rate refunding bonds, due 2013, the interest rate during 1985 was 7.375% until November 1, 1985 and 5.875% thereafter. The bonds may be required to be repurchased at the holder's option and are subject to mandatory redemption upon the occurrence of certain events and are redeemable at the option of the Company under certain circumstances.

(5) These bonds are supported by a long-term irrevocable letter of credit issued by a bank and bear interest at such rate, determined annually, as will cause the bonds to have a market value which approximates, as nearly as possible, their par value. During 1985, the bonds bore interest at a weekly interest rate ranging from 5.05% to 6.75% until May 19, 1985 and 5.625% thereafter. The bonds may be required to be repurchased at the holder's option and are subject to mandatory redemption upon the occurrence of certain events and are redeemable at the option of the Company under certain circumstances.

(6) These bonds are supported by a long-term irrevocable letter of credit issued by a bank and bear interest at a weekly, daily or term interest rate (6.125% at December 31, 1985). The bonds may be required to be repurchased at the holder's option and are subject to mandatory redemption upon the occurrence of certain events and are redeemable at the option of the Company under certain circumstances.

(7) At the option of the Company, the interest rates on the notes due 1987 and 1988 (8.5% and 8.563% at December 31, 1985) may be determined using the bank's prime rate, a CD or LIBOR rate. These notes may be prepaid at the option of the Company without premium.

(8) Secured by properties of the Subsidiary and other assets of the Subsidiary.

(9) Consists of advances to the Subsidiary on two promissory notes which provide for aggregate borrowings in the amount of $60,000,000 with interest at 12.75% per annum for the renovation of a building and construction of additional facilities. Interest is payable quarterly until October 1, 1986 when equal quarterly installments of $2,000,000 of principal and interest shall begin. At

January 1, 1996, the estimated unpaid principal balance in the amount of $54,000,000 is due and payable in full. The loan is secured by the properties and other assets to which it relates, the Subsidiary's pledge of approximately $30,000,000 of its preferred stock portfolio and temporary cash investments and certain other collateral of the Subsidiary.

(10) The unsecured notes due in 1989 have interest rates of 14.125% and 14% per annum. Due in 1990, are two notes, one of which has an interest rate of 13% per annum and the other is fixed (approximately 10.365%) pursuant to the terms of an interest-rate exchange agreement with the lending bank. The unsecured note due 1992 is floating rate, 8.70% at December 31, 1985.

(11) In 1980 the Company leased a turbine and certain other related equipment from the trust-lessor for a twenty-year period with renewal options for up to seven more years. Semi-annual lease payments, including interest, which began in January 1982, are $719,000 through January 1991, and $861,000 thereafter to July 2000. The effective annual interest rate implicit in this lease is calculated to be 9.6%. The total cost of the equipment to the trust-lessor of $11,800,000 plus $1,094,000 interest accrued is reflected in long-term obligations at December 31, 1985. A gain to the Company related to the sale of the turbine to the trust in the amount of $2,343,000 is being amortized to income over the term of the lease.

(12) In January 1985 and December 1985, the Company entered into lease arrangements with an independent trust with respect to the loading of batches 1 through 8 at Unit 1 and batches 1 through 13 at Unit 2 at Palo Verde Station. The Company is accounting for the leases as capital leases and, accordingly, has recorded the obligations in the amount of $25,552,000 for Unit 1 and $27,090,000 for Unit 2 at December 31, 1985 (interest rate of 9.4% at December 31, 1985). Quarterly lease payments based on units of heat production with respect to Unit 1 began in the first quarter of 1986 and are projected to begin for Unit 2 in the fourth quarter of 1986 following commencement of commercial operation.

Scheduled maturities of long-term obligations and sinking fund requirements at December 31, 1985 are as follows (in thousands):

1986	$ 22,993
1987	105,447
1988	97,607
1989	107,747
1990	32,609

On February 11, 1986, the Company completed a $70 million financing by means of a floating rate five-year note secured by Second Mortgage Bonds.

H. Short-Term Obligations

At December 31, 1985, the short-term obligations of the Company and the Subsidiary totaled approximately $38,048,000. Such obligations consisted of notes payable banks, notes payable other and commercial paper. The Company and the Subsidiary also maintained informal lines of credit which totaled approximately $143,000,000 and $19,800,000, respectively, at December 31, 1985. Most of these arrangements provide for the payment of lines of credit fees of various negotiated amounts. At December 31, 1985, the Company and the Subsidiary had $13,000,000 and $11,200,000, respectively, of advances outstanding under their respective lines of credit. The Subsidiary borrows independently from third parties, without recourse to the Company (except for certain borrowings pursuant to the Company's nuclear fuel and fuel oil financing arrangements) for the purposes of its various investments and activities.

The amount of short-term obligations which the Company may incur is regulated by the FERC. The FERC has authorized the Company to incur short-term obligations, with maturities no later than December 31, 1986, in an amount not to exceed $200,000,000 outstanding at any one time.

I. Federal Income Taxes

The provisions (credits) for deferred Federal income taxes, which arise from timing differences between financial and tax reporting are as follows:

	Years Ended December 31,		
	1985	1984	1983
		(In thousands)	
Tax effect of:			
Operating income:			
Depreciation differences	$ 7,365	$ 3,424	$ 1,791
Deferred fuel revenues	2,779	(2,145)	(3,629)
Allowance for borrowed funds used during construction	19,178	20,562	14,920
Taxes capitalized	3,166	2,762	2,694
Nuclear fuel interest	3,104	4,367	9,605
Capitalized Palo Verde operation and maintenance expenses	3,763	443	—
Other	(906)	(1,134)	(3,463)
Other income:			
Tax leases	4,733	5,661	5,619
Other	2,903	1,911	584
	$ 46,085	$ 35,851	$ 28,121

Federal income tax provisions are less than the amounts computed by applying the statutory rate of 46% to book income before Federal income taxes. Details are as follows:

	Years Ended December 31,		
	1985	1984	1983
		(In thousands)	
Tax computed at statutory rate	$ 71,216	$ 69,618	$ 57,351
Decreases due to:			
Allowance for equity funds used during construction	(26,381)	(25,145)	(19,164)
Other	(3,089)	(1,415)	(771)
Total Federal income tax expense	$ 41,746	$ 43,058	$ 37,416
Effective Federal income tax rate	26.96%	28.5%	30.0%

	Years Ended December 31,		
	1985	1984	1983
		(In thousands)	
Current income taxes:			
Operating	$ 1,503	$ 10,818	$ 9,730
Other income	(2,078)	(9,144)	(6,792)
Total	(575)	1,674	2,938
Deferred income taxes:			
Operating	38,449	28,279	21,918
Other income	7,636	7,572	6,203
Total	$ 46,085	35,851	28,121
Charge (benefit) equivalent to investment tax credit:			
Operating	(217)	3,105	6,860
Other income	(3,044)	2,931	—
Total	(3,261)	6,036	6,860
Amortization of investment tax credit:			
Operating	(499)	(499)	(499)
Other income	(4)	(4)	(4)
Total	(503)	(503)	(503)
Total Federal income tax expense	$ 41,746	$ 43,058	$ 37,416

At December 31, 1985, the Company and the Subsidiary had available for Federal income tax purposes an investment tax credit carryforward aggregating approximately $68,900,000 and a rehabilitation tax credit carryforward of $1,250,000 both of which expire during the period 1996 through 2000.

At December 31, 1985, the cumulative net amount of income tax timing differences on which deferred income taxes have not been provided approximated $18,000,000.

J. Commitments and Contingencies

The Company has approximately a 15.8% interest in three units of the Palo Verde Station and related transmission lines and switchyard presently under construction. Transmission lines represent approximately 3% of the estimated aggregate costs of these projects. The estimated aggregate costs of these projects to be incurred by the Company subsequent to December 31, 1985 are approximately $119,800,000, which does not include AFUDC (net of related deferred tax) in the amount of $62,400,000. See Part I, Item 1 — "Construction and Financing Programs — Future Financing" included elsewhere herein and Note G of Notes to Consolidated Financial Statements.

Other construction commitments for the Company subsequent to December 31, 1985 total approximately $64,700,000, which does not include AFUDC (net of related deferred tax) in the amount of $9,400,000.

The Company has a nuclear fuel purchase commitment with an independent trust. The trust purchases nuclear fuel and incurs costs related to a uranium venture under various Company assigned agreements. Under the terms of an agreement dated January 4, 1979, the Company has the option for each batch of either purchasing the fuel from the trust or leasing the heat generated by the fuel at prices established to reimburse the trust for all the costs incurred in connection with acquisition of the fuel (which aggregated approximately $41,600,000 at December 31, 1985). The Company intends to elect the lease option as the basis for payment for future fuel loadings. See Note G of Notes to

Consolidated Financial Statements for amounts already leased from the independent trust. The trust's financing is based upon a letter of credit with a three-year term which is annually extended by one year if notice to the contrary is not given to the trust by the issuing bank. The letter of credit is currently scheduled to expire on January 8, 1989, but it will be automatically extended to January 8, 1990 if the issuing bank does not notify the trust otherwise by the required date in 1986.

The Company and its Subsidiary are involved in litigation and are subject to certain claims which arise in the normal course of business, none of which, in the opinion of management, is expected to have a material adverse effect on the Company's consolidated financial position.

K. AFUDC

The Company used a weighted average accrual rate of 12.2%, 13.1% and 12.9% for AFUDC in 1985, 1984 and 1983, respectively. Certain amounts of CWIP have been allowed in the Company's rate base or made the basis of extraordinary cash rate relief, and the appropriate amounts have been excluded from the CWIP balance used as a base for calculating AFUDC.

L. Pension Plan

The Company's Retirement Income Plan (the plan) covers employees who have completed one year of service with the Company and/or the Subsidiary. The plan is a noncontributory defined benefit plan. Upon retirement or death of a vested plan participant, assets of the plan are used to purchase an annuity contract with an insurance company.

Contributions from the Company and Subsidiary are based on the amounts required to be funded under provisions of the plan as actuarially calculated. The weighted average assumed rate of return used in determining the actuarial present value of accumulated plan benefits presented below was 8% compounded annually.

Net assets available for plan benefits and the actuarial present value of accumulated plan benefits as of the two most recent actuarial determination dates are presented below:

	January 1, 1985	July 1, 1984
	(In thousands)	
Net assets available for plan benefits	$21,970	$20,393
Actuarial present value of accumulated plan benefits:		
Vested benefits:		
Participants currently receiving payments	$ 8,195	$ 7,955
Other participants	14,949	12,523
	23,144	20,478
Nonvested benefits	1,063	952
Total actuarial present value of accumulated plan benefits	$24,207	$21,430

The pension cost in 1985, 1984 and 1983 was $1,448,000, $1,544,000 and $1,502,000, respectively, which includes amortization of past service cost over a thirty-year period beginning in 1972.

M. Selected Quarterly Financial Data (Unaudited)

	Operating Revenues	Operating Expenses	Operating Income	Net Income	Net Income Applicable to Common Stock	Net Income Per Share of Common Stock
	(In thousands of dollars except for per share data)					
1985						
1st quarter	$80,470	$60,330	$20,140	$28,078	$24,300	$.72
2nd quarter	85,468	64,849	20,619	26,005	22,337	.66
3rd quarter	98,903	75,962	22,941	32,256	28,587	.83
4th quarter	74,750	55,154	19,596	26,732	23,093	.67
1984						
1st quarter	$75,426	$56,648	$18,778	$26,360	$23,980	$.74
2nd quarter	82,667	62,467	20,200	27,817	24,473	.75
3rd quarter	93,084	71,394	21,690	29,415	25,614	.77
4th quarter	77,838	59,563	18,275	24,694	20,904	.62

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

SUPPLEMENTAL INFORMATION CONCERNING THE EFFECTS OF INFLATION (Unaudited)

The following supplementary information is supplied in accordance with the requirements of FASB Statement No. 33, Financial Reporting and Changing Prices and FASB Statement No. 82, Financial Reporting and Changing Prices: Elimination of Certain Disclosures, for the purpose of providing certain information about the effects of changing prices. It should be viewed as an estimate of the approximate effect of inflation, rather than as a precise measure.

Constant dollar amounts represent historical costs stated in terms of dollars of equal purchasing power, as measured by the Consumer Price Index for All Urban Consumers. Current cost amounts reflect the changes in specific prices from the date the plant was acquired to the present, and differ from constant dollar amounts to the extent that specific prices have increased more or less rapidly than prices in general.

The current cost of utility plant and nonutility property, net of accumulated depreciation and amortization, represents the estimated cost of replacing existing plant assets and was determined by indexing the surviving plant by the Handy-Whitman Index of Public Utility Construction Costs.

The current year's provision for depreciation and amortization on the current cost amounts of plant was determined by applying effective depreciation and amortization rates to the indexed plant amounts.

Fuel inventories and the cost of fuel used in generation have not been restated from their historical cost in nominal dollars. Regulation limits the recovery of fuel costs through the operation of adjustment clauses or adjustments in basic rate schedules to actual costs. For this reason fuel inventories are effectively monetary assets.

As prescribed in FASB Statement No. 33, income taxes were not adjusted.

Under the rate making prescribed by the regulatory commissions to which the Company is subject, only the historical cost of plant is recoverable in revenues as depreciation. Therefore, the excess of the cost of plant stated in terms of current cost over the historical cost of plant is not presently recoverable in rates as depreciation and is reflected as a reduction to net recoverable cost. While the rate making process gives no recognition to the current cost of replacing plant assets, based on past practices, the Company believes it will be allowed to earn on the increased cost of its net investment when replacement of facilities actually occurs.

To properly reflect the economics of rate regulation in the Supplemental Consolidated Statement of Income from Operations Adjusted for Changing Prices, the excess of increase in general price level over increase in specific prices at net recoverable amount should be offset by the gain from decline in purchasing power of net amounts owed on a current cost basis. During a period of inflation, holders of monetary assets suffer a loss of general purchasing power while holders of monetary liabilities experience a gain. The purchasing power gain on net monetary items owed is equal to the net gain found in restating in current cost dollars the opening and closing balances of, and transactions in, monetary assets and liabilities. The gain from the decline in purchasing power of net amounts owed is primarily attributable to the substantial amount of debt which has been used to finance plant assets. Since the depreciation on plant is limited to the recovery of historical costs, the Company does not have the opportunity to realize a holding gain on debt and is limited to recovery only of the embedded cost of debt capital.

Restated net assets (which is equal to common stock equity and preferred stock) is measurable by adjusting the amount reported for net assets in the balance sheets for the difference between the historical cost and the restated current cost dollar amounts or lower recoverable amounts of property less reserves. Because of the lower recoverable amounts provision, the determination of net assets for a

utility company is based on the historical cost at year end, after conversion to current cost dollars, with no aging of property required. FASB Statement No. 33 did not define what should be included in net assets, leaving the calculation open to experimentation. The Company calculates net assets by restating net utility plant, net nonutility property and monetary items on a current cost basis.

Inferences which, in the case of some industries may be drawn from information in the nature of that presented below as to the adequacy of future cash flows in relation to future plant replacement requirements are believed by the Company to be less valid in the case of public utilities which, like itself, should be able to establish rates to cover increased costs of new plant. However, the information may provide some indication of the expanded capital structure that will be required for making plant replacements and additions with inflated dollars.

Consolidated Statement of Income from Operations Adjusted for Changing Prices for the Year Ended December 31, 1985

	Conventional Historical Cost	Current Cost Average 1985 Dollars
	(In thousands)	
Operating revenues	$339,591	$339,591
Fuel, purchased and interchanged power	131,367	131,367
Other operating and maintenance expenses	70,937	70,937
Depreciation and amortization	14,755	31,927
Federal income taxes	39,236	39,236
Interest expense	35,778	35,778
Other income	(65,553)	(65,553)
	226,520	243,692
Net income	$113,071	$ 95,899
Increase in specific prices (current cost) of plant held during the year(1)		$ 36,772
Reduction of plant to net recoverable amount		2,808
Effect of increase in general price level		(79,996)
Excess of increase in general price level over increase in specific prices at net recoverable amount		(40,416)
Gain from decline in purchasing power of net amounts owed		33,685
Net		$ (6,731)

(1) At December 31, 1985, current cost of plant net of accumulated depreciation was $2,308,268,000, while historical cost or net amount expected to be recoverable through depreciation was $1,759,437,000.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

SUPPLEMENTAL INFORMATION CONCERNING THE EFFECTS OF INFLATION (Unaudited) — (Continued)

Five Year Comparison of Selected Supplementary Financial Data Adjusted for Effects of Changing Prices (Note)

	Years ended December 31,				
	1985	1984	1983	1982	1981
	(In thousands except for per share amounts)				
Operating revenues:					
Historical cost	$339,591	$329,015	$302,443	$271,048	$250,965
Constant dollars	339,591	340,645	326,565	302,081	296,846
Net income:					
Historical cost	$113,071	$108,286	$ 87,261	$ 70,888	$ 56,697
Current cost	95,899	94,640	76,638	62,953	52,074
Net income per share of common stock:					
Historical cost	$ 2.88	$ 2.88	$ 2.48	$ 2.30	$ 2.23
Current cost	2.38	2.45	2.12	1.99	1.97
Net assets at year-end at net recoverable amounts:					
Historical cost	$712,073	$655,740	$545,167	$468,090	$372,823
Current cost	700,763	669,666	578,757	515,795	426,728
Excess of increase in general price level over increase in specific prices at net recoverable amount, current cost	$ 40,416	$ 35,501	$ 27,328	$ 20,904	$ 52,742
Other information:					
Gain from decline in purchasing power of net amounts owed, current cost	$ 33,685	$ 29,563	$ 24,811	$ 20,002	$ 38,213
Cash dividends declared per share of common stock:					
Historical cost	$ 1.49	$ 1.43	$ 1.37	$ 1.31	$ 1.25
Constant dollars	1.49	1.48	1.48	1.46	1.48
Market price per share of common stock at year-end:					
Historical cost	$ 15.50	$ 13.00	$ 13.38	$ 12.25	$ 10.88
Constant dollars	15.25	13.27	14.20	13.50	12.47
Average consumer price index	322.2	311.2	298.4	289.1	272.4

Note: Constant dollars and current cost amounts are stated in average 1985 dollars.

Item 9. Disagreements on Accounting and Financial Disclosure

Not applicable.

PART III

Item 10. Directors and Executive Officers of the Registrant

Information regarding directors is incorporated herein by reference from the 1986 Proxy Statement. Information regarding executive officers of the Company, under the caption "Executive Officers of Registrant" in Part I, Item 1 above, is incorporated herein by reference.

Item 11. Executive Compensation

Incorporated herein by reference from the 1986 Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management

Incorporated herein by reference from the 1986 Proxy Statement.

Item 13. Certain Relationships and Related Transactions

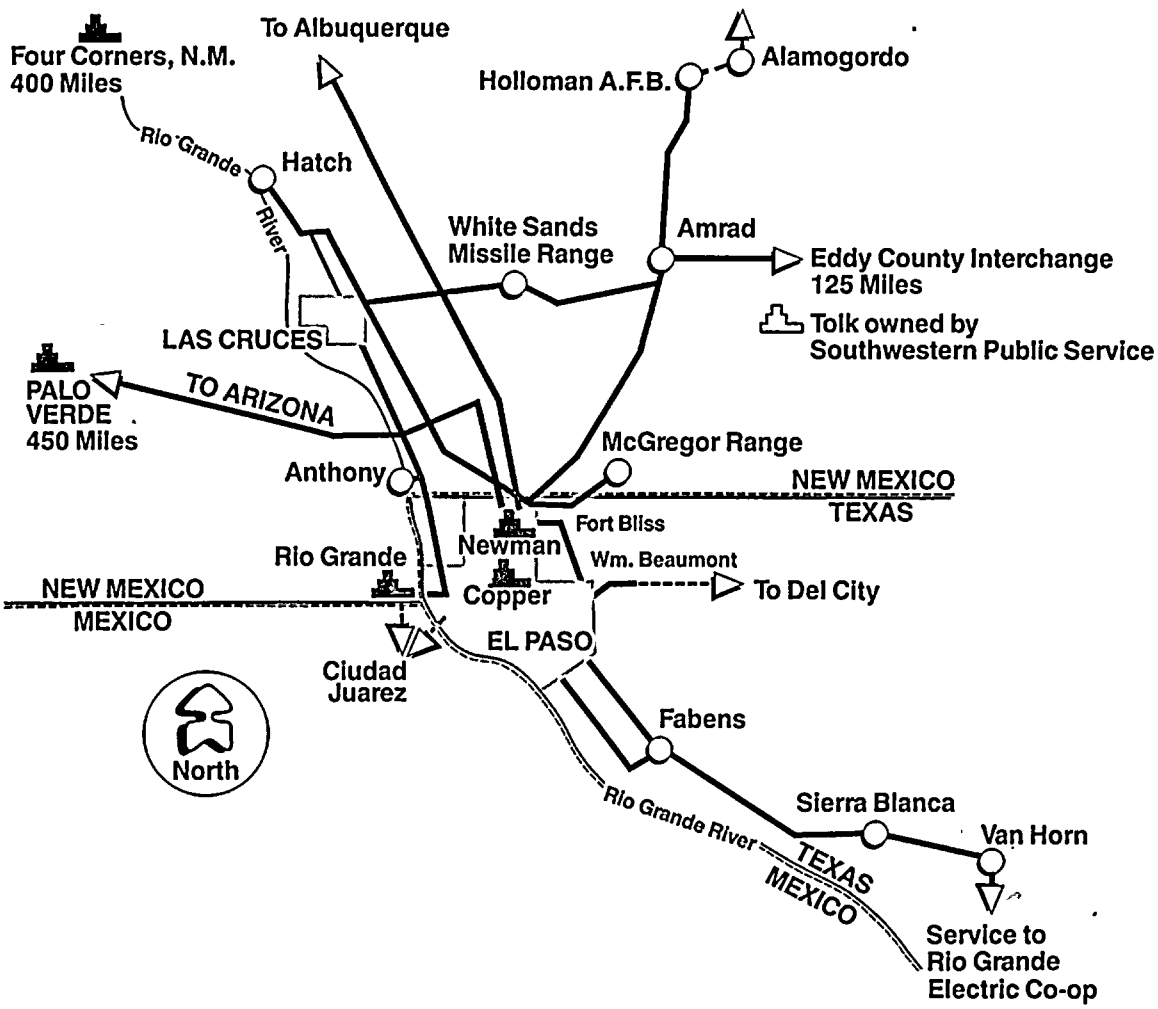
Incorporated herein by reference from the 1986 Proxy Statement.

PART IV

Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

The information required by this Item has been omitted from this Annual Report to Shareholders.

SERVICE AREA



COMPANY LINES

MAJOR DISTRIBUTION STATIONS

GENERATING STATIONS

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

Bulk Rate
U.S. Postage
PAID
El Paso, Texas
Permit No. 152

The Electric Company