EL PASO ELECTRIC COMPANY

1986 ANNUAL REPORT

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1986 HIGHLIGHTS

	December 31, 1986		December 31, 1985	
Operating Revenues (000)	$ 318,109		$ 339,591	
Operating Expenses (000)	$ 230,734		$ 256,295	
Net Income (000)	$ 95,614		$ 113,071	
Net Income Per Common Share	$ 2.32		$ 2.88	
Dividends Paid Per Common Share	$ 1.52		$ 1.49	
Book Value Per Common Share	$ 16.99		$ 16.19	
Common Shares Outstanding	35,510,138		34,743,917	
Number of Customers	220,465		212,901	
Number of Employees	1,083		1,056	
Total System Peak Load	938,000	KW	877,000	KW
Net Generating Capacity for Peak	1,103,000	KW	989,000	KW
Average Annual Residential Use	5,719	KWH	5,735	KWH
Fuel, Purchased and Interchanged Power Expenses (000)	$ 100,353		$ 131,367	
Total Energy Sales	4,491,304	MWH	4,277,532	MWH

ANNUAL MEETING OF SHAREHOLDERS

All shareholders are invited to attend the Annual Meeting of Shareholders on Monday, May 18, 1987, 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.

Cover: Hand-colored photograph by Vallarie & Arturo Enriquez, Vantage Point ©1987.

Dear Shareholder:

The year 1986 marked 85 years that El Paso Electric has been providing its customers with dependable, safe and economical electric power.

From the earliest days, El Paso Electric's management has worked to provide for the electrical needs of its customers by planning and constructing the expansion of facilities needed by a young and growing economy. To accomplish this effort, El Paso Electric has continually developed and implemented innovative ideas to meet not only the energy needs of its customers, but also financial and community obligations as well.

The stability of your Company has been and will continue to be maintained by its adherence to the primary missions of service to its customers, enhancement of shareholder investment and commitment to employee development.

The year 1986 was significantly important in the area of electric sales by El Paso Electric. Total electrical sales increased 5 percent over 1985. This important increase is attributed primarily to an increase in off-system sales. Native system sales also increased 2.1 percent in 1986 as compared with 1985. Net income per common share declined from $2.88 to $2.32 primarily because of reduction of Allowance for Funds Used During Construction (AFUDC) as a result of the sale and leaseback of Palo Verde Unit 2. Revenues were down 6.3 percent due to lower fuel costs. The number of customers rose 3.5 percent, and the Company's net generating capacity for peak rose 11.5 percent primarily due to Palo Verde Unit 1 coming on-line.

The following significant events surfaced as concerns, challenges and accomplishments during 1986 and paved the way for an exciting future.

Evern R. Wall
President and
Chairman of the Board

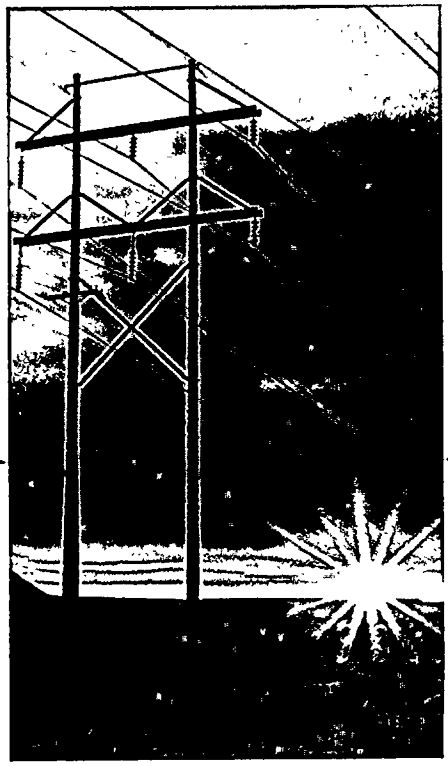
SALE AND LEASEBACK OF PALO VERDE UNIT 2

Perhaps the event that had the most impact on El Paso Electric in 1986 was the consummation of the sale and leaseback of the Company's undivided ownership interest in Unit 2 of the Palo Verde Nuclear Generating Station. In August 1986, after some very long hours and meticulous negotiations, El Paso Electric took a major step in its electric rate moderation efforts by completing the sale and leaseback of 73.5 percent of its 15.8 percent share of Unit 2. In December 1986, the Company sold and leased back its remaining share of the unit. The total consideration received by El Paso Electric from these transactions was approximately $684.4 million.

Since early 1985, El Paso Electric management has worked with various consumer groups, regulatory commission staff members and large electric users, both in Texas and New Mexico, to develop electric rate moderation plans. The purpose of these efforts is to enable El Paso Electric to maintain pricing continuity, without adverse effects on customers, while providing electric rates adequate to meet cash requirements and a reasonable return on shareholder investment. The consummation of the Palo Verde Unit 2 sale and leaseback transaction facilitates El Paso Electric's ability to implement electric rate moderation plans in its service area. Because the Company is leasing Unit 2 pursuant to long-term leases, with certain purchase and lease renewal options, the Company's ability to meet the electric needs of its customers will not be affected by the transaction.

The financial advantages of selling and leasing back Unit 2 are twofold. First, the cost of capital to El Paso Electric is reduced because the investors who purchased Unit 2 were able to finance a greater portion of the unit at a lower cost; in addition, the tax benefits which were transferred to the investors as part of the sale provided greater current benefits to the investors, thereby lowering the cost of leasing the asset. Secondly, revenue requirements associated with Unit 2, to be recovered through rates, were leveled over the term of the leases, when compared to the revenue requirements that would be associated with the unit under traditional rate base treatment. This feature allows the rate moderation plan to provide price continuity for electric customers.

The Unit 2 sale and leaseback transactions will not eliminate the need for the Company to file future rate increases. The Company will still need to recover the costs of Palo Verde Units 1 and 3 and lease payments on Unit 2. However, the rate increases needed will be substantially lower than they would have been if the Company had retained full ownership of the unit.



Energy for a new tomorrow

THE PALO VERDE NUCLEAR GENERATING STATION

In 1986, as in 1985, the Palo Verde Nuclear Generating Station continued the transition from construction to operation. Unit 1 of Palo Verde began operating at the 100 percent power level in December 1985 and went into commercial operation for ratemaking purposes in February 1986. In March 1986, the unit underwent a 10-week surveillance/maintenance outage required by the Nuclear Regulatory Commission (NRC). Plant personnel successfully completed the required inspection, and the reactor was restarted on May 23, 1986, and was again brought up to the 100 percent level.

In April 1986, the NRC unanimously approved a full power license for Unit 2, which cleared the way for its power ascension testing. The unit was synchronized to the main transmission grid on May 20, 1986. It was at that time that El Paso Electric customers first began receiving electrical power from the unit. Unit 2 reached the 100 percent power level in September 1986, and the Company has applied to the Public Utility Commission of Texas (PUCT) for a determination that Unit 2 went into commercial operation on September 22, 1986. By putting to use the experience of bringing Unit 1 on-line, Palo Verde plant personnel were able to complete the power ascension testing for Unit 2 in less than two-thirds the time it took for Unit 1.

In October 1986, Unit 2 produced 987,300 megawatt-hours of gross electrical output, more electricity than any other commercial nuclear unit in the United States has ever produced during a one-month period. This amount of power constitutes enough electricity to serve 1 million residential customers during an average month.

Construction of Unit 3 is 99.9 percent complete. The unit has successfully undergone its pre-core hot functional tests and fuel loading will be completed soon. The unit is scheduled to attain commercial operation before the end of 1987. When that milestone is reached, El Paso Electric's goal of generating 80 percent of the energy used by area customers through the use of uranium and coal will have been realized.

In a continuing effort to acquire the lowest nuclear fuel costs, the Arizona Power Nuclear Power Project has negotiated a new nuclear fuel contract. The new contract is estimated to save the project approximately $124 million in total fuel costs. The annualized savings are approximately $15 million over the 8 year life of the base contract. The expected savings to El Paso Electric customers amount to more than $2.3 million a year during that same time period of the contract.

Palo Verde photograph provided by A.N.P.P. Photo Service Department.

RATES AND REGULATION

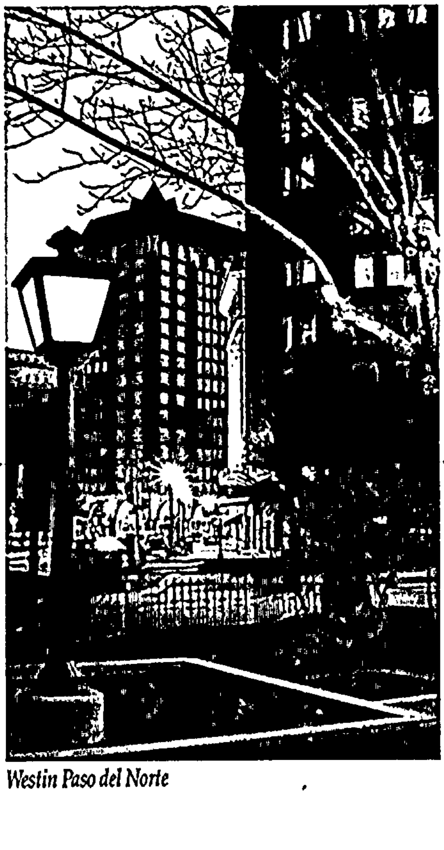
Texas

El Paso Electric did not file a request for a rate increase in its Texas service area during 1986. The Company will file a rate increase request for its Texas service area during the spring of 1987 based on a September 1986 test year. The Company will seek inclusion in rates of Palo Verde Unit 1 as "plant in service." The Public Utility Commission of Texas (PUCT) declared Palo Verde Unit 1 to be "in service" as of February 24, 1986. The Company will also request in its rate increase application the lease and operating expenses for Unit 2 and increases in normal operating expenses. The Company has filed an application with the Commission requesting Unit 2 be declared "in service" as of September 22, 1986. A decision is pending on this request.

The PUCT issued a final order in the Company's 1985 rate case in January 1986. The Commission ordered the Company to reduce its non-fuel base rates by approximately $14.3 million. In March 1986, this order was appealed by the Company to state district court. The district court denied a request by the Company for an injunction of the order pending review by the court. The Company's appeal to the court of appeals for a stay of the PUCT order was granted pending a review of the district court's refusal to grant the injunction. On January 21, 1987, the court of appeals lifted the stay. The Company has filed a motion for rehearing before the court of appeals and intends to pursue all available legal means in regard to the appeal of the 1985 rate case and the implementation of lower rates as ordered.

During 1986 and the first quarter of 1987, the Company filed three requests with the PUCT to refund approximately $22.6 million in over-recovered fuel charges to its Texas customers. Because of the abolishment of the monthly fuel adjustment clause by the Texas Legislature in 1983, the Company is unable to pass its fuel savings to its customers immediately. Instead, the Company must file an application to change the monthly fuel factor as set by the Commission.

In November 1986, the Company received authorization to implement a lower fuel factor in December 1986. The Company's lower fuel factor is the result of lower natural gas prices and the availability of lower priced economy purchases from other electric utilities.



Westin Paso del Norte

New Mexico

The Company's current rates in New Mexico are based on a rate order by the New Mexico Public Service Commission issued in February 1986 that allowed the Company to increase its non-fuel base revenues by approximately $7 million. The Commission order, effective with billings in April 1986, allowed Palo Verde Unit 1 and one-third of Common Plant into rates as "plant in service."

On January 30, 1987, the Company, utilizing traditional rate methodology, filed for a rate increase in its New Mexico jurisdiction. The request was for an approximate $18.7 million base revenue increase that results in a total increase of approximately $13.9 million after fuel savings. The increase was primarily based on inclusion in rates for the operating expenses for Palo Verde Units 1 and 2 and lease payments for Unit 2.

During 1986, the New Mexico Commission consolidated past electric rate moderation efforts into a formal proceeding. Though the Company has requested traditional rate relief in its January 1987 filing, it is currently working in an effort to achieve a viable electric rate moderation plan.

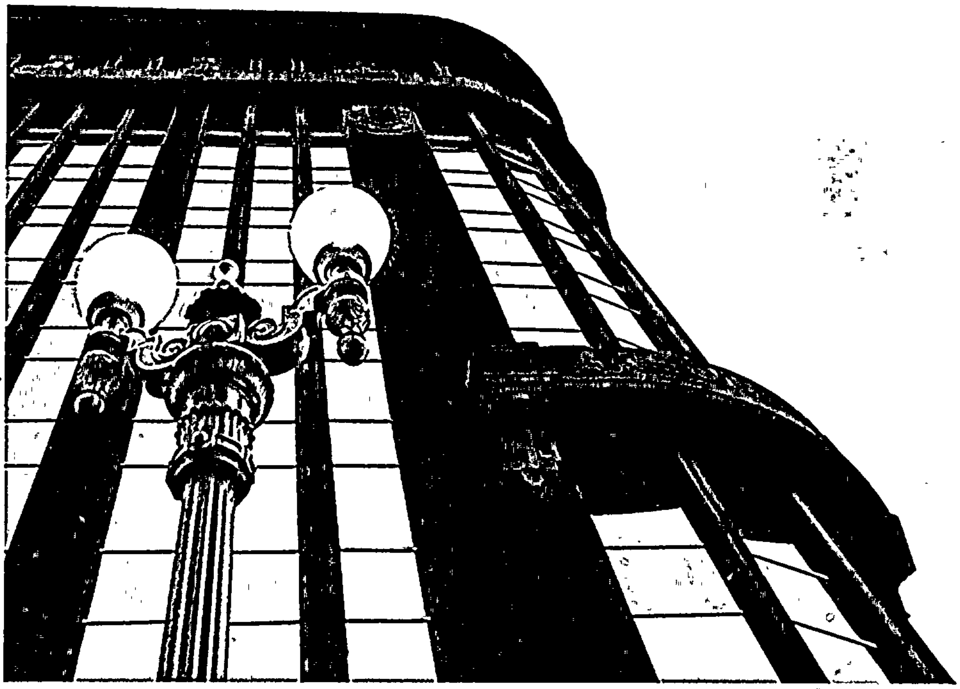
In March 1987, El Paso Electric entered into a stipulated agreement with the New Mexico Commission Staff and various customer groups for the purpose of moderating rates and resolving the prudence and excess capacity issues as they relate to the Company's investment in Palo Verde. Part of the stipulation also includes an agreement that rate base treatment of Unit 1 continue and that the Company's share of Unit 3 be removed from New Mexico regulation. This stipulated agreement provides for a rate path through 1994 that establishes rate stability for the Company and its New Mexico customers. This plan represents the culmination of several years of effort by the Company and various regulatory and customer groups to achieve a plan that is in the interest of the Company and its customers. The stipulation will require approval by the New Mexico Public Service Commission.

Federal Energy Regulatory Commission

In March 1986, the Company filed a two-step rate increase request with the Federal Energy Regulatory Commission (FERC) for its three wholesale customers – Imperial Irrigation District, Texas-New Mexico Power Company and the Rio Grande Electric Cooperative. In May 1986, FERC granted El Paso Electric authority to place approximately 80 percent of the requested increase in effect subject to refund. Rate settlements were reached with each wholesale customer in the fourth quarter of 1986, and the Company is currently awaiting FERC approval on these settlements.

By virtue of one of these settlements, the Company took a significant step toward electric rate moderation by executing a long-term power sales agreement with the Imperial Irrigation District (IID) in Imperial, California. The agreement provides for the sale by the Company to IID of 100 megawatts of firm power through April 2002, and an additional 50 megawatts of interruptible power between May 1992 and April 2002.

A settlement in principle was also reached with Texas-New Mexico Power providing for long-term capacity sales through 2002 in exchange for an agreement on the capacity rates over the life of the agreement.



The Mills Building

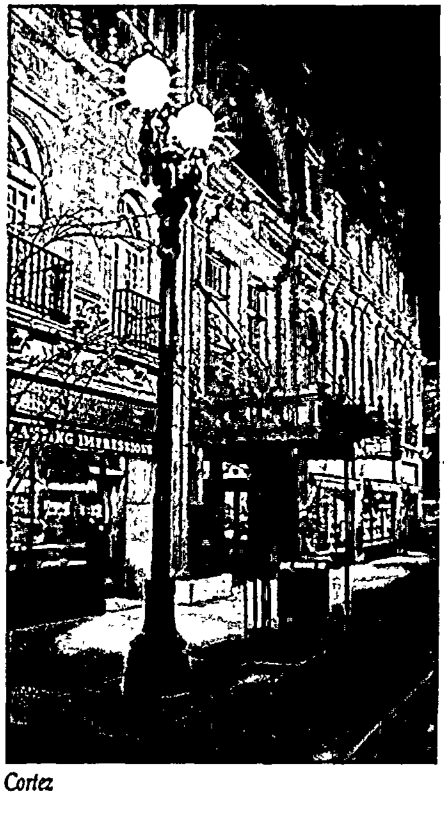
1986 SUBSIDIARY ACTIVITIES

In 1901, the year El Paso Electric Company was founded, the downtown El Paso area was the hub of local and international business activity. Eighty-five years later El Paso Electric's wholly owned subsidiary, Franklin Land & Resources, Inc., has emerged as the leader in a movement to revitalize the El Paso downtown area. The plan is to again make the downtown area a successful business district. Through innovative uses of the subsidiary, four downtown historical landmarks, which undoubtedly would have been destroyed, have been saved. Three of the buildings have been renovated and are currently being operated as successful businesses. The Mills Building is currently the corporate headquarters of El Paso Electric; the Cortez Building, which first opened its doors in 1925 as a grand hotel, is now a luxurious office complex, and the Paso del Norte Hotel has reopened as the Westin Paso del Norte. The renovation of these three grand structures has built enthusiasm and excitement for the preservation and additional development of downtown El Paso.

The Westin Paso del Norte opened its doors on June 24, 1986, and as the name indicates, uniquely blends the old with the new. The original Paso del Norte Hotel, which opened in 1912, has been renovated and now stands alongside a beautiful new 17-story addition. This restoration and revitalization effort has provided El Paso with one of the most elegant hotels in the Southwest. Because of its historical charm and reputation and close proximity to the El Paso Civic Center, the Westin Paso del Norte has had a very positive effect on El Paso's convention business. City Convention Bureau reports show that convention bookings have increased more than 100 percent and that 60 percent of these conventions will utilize the Paso del Norte in one capacity or another.

The fourth historic structure that Franklin Land has purchased is The Palace, an old movie theater. Plans are underway, with the help of governmental and civic organizations, to establish an Arts Block. This renovated downtown block would house arts and science museums, studio spaces for visual arts, rehearsal spaces for actors and dancers and office space for non-profit arts and cultural organizations. The anchor attraction would be The Palace which could be refurbished to seat 750 and used by local non-profit performing organizations. The acquisition of The Palace Theater and the plans which are being developed for it hold much excitement for the El Paso arts community.

El Paso Electric has shown, through the success of Franklin Land & Resources, that in addition to providing for its customers' electric power needs, the Company can also take the lead in improving the quality of life in El Paso.



Cortez

1986 AND BEYOND

During the past few years, management of the Company has been confronted with many uncertainties; rate reductions have been ordered by the Public Utility Commission of Texas; Company operations were curtailed in order to compensate for a critical cash flow problem; and new questions were raised about the safety of nuclear power plants.

As 1986 progressed and successes began to be realized, brighter days seemed ahead like the beginning of a New Dawn. The Palo Verde Unit 2 sale and leaseback transactions helped relieve some of the cash flow problem, and the Company was able to return to a more normal operations mode. Educational programs for employees, which had been suspended, were reinstated; salaries and wages which had been frozen, were normalized; projects which had been deferred were begun; and the questions on nuclear power plant safety have for the most part been eased. It is time to look optimistically to the future.

The future of the Company is directly correlated with the future of the El Paso and Las Cruces area. The Company has always taken great pride in being involved with the communities which it serves. In more recent times, however, its involvement was forced to be curtailed. With the many positive events that occurred in 1986, that much needed involvement is beginning to grow again.

Financial contributions by the Company are a very important part of community involvement. To facilitate this effort, the Del Norte Foundation was established to act as a conduit for charitable contributions to various charities located in the Company's service area. The Company plans to ultimately fund the foundation with a $3 million contribution which will be invested, and income from the investments will be used for donations in accordance with the specified purposes of the foundation. Contributions will be made to organizations engaged in education, health and medical service, civic work, youth services and culture and arts.

In addition, the Company recognizes the need for a healthy economy and the important role new business development plays in strengthening the El Paso/Las Cruces area. These were the reasons behind the establishment of the Rio Bravo Industry Development Corporation. The new corporation will help existing industry as well as attract new industry to the Company's service area. This effort will directly benefit the community by increasing employment opportunities and will benefit shareholders by increasing the electrical usage, all of which will enhance the economy of the community. The Rio Bravo Industry Development Corporation will be financed with the income from a $10 million investment by the Company.

While the Company has experienced a number of accomplishments during 1986, there are still major problems in the regulatory arena which must be solved. El Paso Electric must receive rate increases to cover the cost of the investment in the Palo Verde Nuclear Generating Station over its useful life. The Company must also continue to seek to find ways to moderate these increases so as not to affect the customer base in a way which will damage the overall business. These and all other challenges must be and will be met by your Company.

For 85 years El Paso Electric Company has prevailed as a business and community leader in the El Paso/Las Cruces area. That strong distinction can be attributed to the courage and dedication of the Company's officers, employees and Board of Directors, who have continued to meet the obstacles and challenges.

The stability of El Paso Electric is also attributed to you, our shareholder, who by your continuing support of our efforts, help all of us strive for productive goals and achievements.

1986, the year El Paso Electric celebrated its 85th anniversary, may also very well be the year of a New Dawn.

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 DISCONTINUED

The El Paso Electric Company Board of Directors elected to terminate the Dividend Reinvestment Plan effective December 31, 1986. Participants in the Plan were issued certificates for the number of real shares held in the Plan, together with a check for any fractional share, during the first quarter of 1987. The Company may consider another type of reinvestment program in the future. If that occurs, each Shareholder will be notified by mail.

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, 1986, was 49,733. Our records indicate that about 79 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 (29)
Charles Mais, Senior Vice President (32)
Ignacio R. Troncoso, Vice President (17)
Lawrence M. Downum, Jr., Vice President (26)
William J. Johnson, Vice President and Treasurer (9)
William W. Royer, Vice President and General Counsel (6)
Joseph E. Wasiak, Vice President (9)
James P. Maloney, Vice President (1)
Robert L. Corbin, Vice President (38)
Theta S. Fields, Secretary/Assistant to the President (36)
Eduardo A. Rodriguez, Assistant General Counsel/Assistant Secretary (5)
Robert N. Hackett, Assistant Vice President (15)
Robert W. Waugh, Assistant Vice President (19)
C. R. Becker, Assistant Treasurer (9)
Cecelia R. Shea, Assistant Secretary (28)

Years of Service ( )

DIRECTORS OF THE COMPANY

Evern R. Wall, President and Chairman of the Board (12)
Wilfred E. Binns, Contractor; Owner, Binns Construction and Realty (4)
Robert H. Cutler, Chairman of the Board, Cutler Corporation (17)
H.M. Daugherty, Jr., Chairman of the Board and Chief Executive Officer, MBank El Paso N.A. (4)
Leonard A. Goodman, Jr., Chartered Life Underwriter/General Agent, John Hancock Financial Services (8)
Ben L. Ivey, Farming (17)
Josefina A. Salas-Porras, Secretary-Treasurer, Sunland Motor Sports, Inc. (8)
Tom C. Simpson, President, Simpson Farms Inc.; President, Simpson Cattle and Feed Company (4)
Tad R. Smith, Attorney, Kemp, Smith, Duncan and Hammond; Counsel for the Company (26)

Years of Service ( )

Seated from left to right: Tad R. Smith, Josefina A. Salas-Porras, Chairman Evern R. Wall, Robert H. Cutler, and Tom C. Simpson. Standing: Ben L. Ivey, Wilfred E. Binns, H.M. Daugherty, Jr., and Leonard A. Goodman, Jr.

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, 1986	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 27, 1987, the aggregate market value of the voting stock held by non-affiliates of the registrant was $694,985,708.

As of February 27, 1987, there were outstanding 35,513,053 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 18, 1987 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
FL&R	Franklin Land & Resources, Inc., a wholly-owned subsidiary of the Company
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
RGEC	Rio Grande Electric Cooperative, Inc.
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
TEP	Tucson Electric Power Company
Texas Commission	Public Utility Commission of Texas
TNP	Texas-New Mexico Power Company
1987 Proxy Statement	Company's definitive proxy statement for the annual meeting of shareholders to be held on May 18, 1987.

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PART I

Item 1. Business

General

The Company was incorporated in Texas in 1901. It distributes electricity through an interconnected system to approximately 220,000 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. At December 31, 1986, the Company's largest retail customers included 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 derives a significant portion of its operating revenues from wholesale power sales and recently reached rate increase settlements with its three principal wholesale customers. See "Rates and Regulation — Rate Matters — FERC."

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 1986, approximately 70% of the Company's operating revenues were derived from Texas, 18% from New Mexico and 12% from FERC wholesale customers. Sales to (i) residential, (ii) small commercial and industrial, (iii) large commercial and industrial customers and (iv) public authorities accounted for approximately 35%, 34%, 13% and 18%, respectively, of the Company's operating revenues from retail sales. In 1986, a wholesale customer accounted for 8.6% 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 29% of annual revenues due to the climate in the Company's service area. (See Note N of Notes to Consolidated Financial Statements.)

The Company attained an all-time total system peak load of 938 MW on August 13, 1986. In 1985, the Company's total system peak load was 877 MW. In 1986 and 1985, the native system peak load was 790 MW and 778 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 1987-1996 time period is approximately 3.2%. See "Facilities."

The Company had 1,083 employees as of December 31, 1986. Approximately 29% of the employees are covered by a collective bargaining agreement that expires in February 1989.

Company Conditions

The Company's major construction project for a number of years has been related to its 15.8% interest in the Palo Verde Station. Through December 31, 1986, the Company had expended $1.36 billion (including $388 million of AFUDC net of deferred taxes) for its investment in Palo Verde. In separate transactions in August and December 1986, the Company sold and leased back all of its 15.8% interest in Unit 2 at Palo Verde and one-third of its 15.8% interest in certain Palo Verde Common Plant. See "Palo Verde Unit 2 Sale and Leaseback Transactions" below. At December 31, 1986, the Company's remaining ownership interest in Palo Verde aggregated $953 million (including $239 million of AFUDC net of deferred taxes). Estimated remaining construction expenditures related to the Company's interest in Palo Verde aggregate $54.7 million (including $19.9 million of AFUDC net of deferred taxes).

Unit 1 was placed in commercial operation by the Company in December 1985, but, in Texas for rate making purposes, the Texas Commission established February 24, 1986 as the commercial operation date. In December 1986, the Company filed an application to have the Texas Commission set September 22, 1986 as the commercial operation date for Unit 2. Unit 3 is scheduled to commence commercial operation before year end 1987.

With construction at Palo Verde virtually complete, the consummation of the Unit 2 sale and leaseback transactions and the recent settlement reached by the Company in New Mexico, subject to the approval of the New Mexico Commission, regarding rate making treatment in New Mexico of the Company's investment in Palo Verde, the principal factors which will affect the future financial position and results of operations of the Company will be obtaining adequate and timely increases in retail rates in Texas, together with the ability to defer any costs not currently recovered as a result of phased-in rate increases, if such phase-ins occur, and utilization of proceeds from the Unit 2 sale and leaseback transactions for redefinition of its capital structure and investment of such proceeds, including its present plans for diversification, so as to earn an adequate return on the investment of those proceeds. See "Rates and Regulation", "Construction and Financing Programs", "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note B of Notes to Consolidated Financial Statements.

Palo Verde Unit 2 Sale and Leaseback Transactions

In August and December of 1986, the Company consummated eight separate sale and leaseback transactions (one of which has been accounted for as a financing transaction) representing its entire 15.8% undivided interest in Palo Verde Unit 2 and one-third of its undivided interest in certain common facilities at Palo Verde. The eight transactions are collectively referred to in this document as the Unit 2 sale and leaseback transactions. The total consideration received by the Company from such transactions, which was based upon appraised fair market value, was approximately $684.4 million, of which $597 million has been accounted for as operating leases (representing book value of $448.5 million), and $87.4 million which has been accounted for as a financing transaction (representing book value of $65.5 million).

Each of the eight leases have initial terms expiring October 1, 2013. Each lease is a "net lease," which requires the Company to pay all taxes, insurance premiums, operating and maintenance costs, including decommissioning costs, associated with Unit 2. Each lease also allows the Company to extend the term of the lease and to repurchase the leased Unit 2 interest under certain circumstances. The aggregate amount of basic rent payments under the leases is approximately $66 million per year, with the first semi-annual rent payment being due April 1, 1987.

A bank letter of credit was issued to one of the equity investors in the December sale and leaseback transactions to secure the equity investor for the payment of all amounts payable by the Company for the benefit of the equity investor under the lease and related documents. The Company agreed to provide the other equity investor in the December sale and leaseback transactions with a similar bank letter of credit. Such credit support will remain outstanding for five years with respect to one lease and for the primary lease term with respect to the other lease.

Upon the occurrence of specified events of loss or deemed loss events under a lease, the occurrence of each of which events is considered by the Company to be remote, the Company is obligated to pay the equity investor an amount of cash which, primarily because of certain tax consequences, may exceed the equity investor's unrecovered equity investment (the Company's obligation being secured by the above discussed bank letters of credit for the stated periods of time covered by such letters of credit). Upon payment of such amount and assumption of the debt portion of the purchase price of the undivided interest, the undivided interest will be transferred to the Company. Approximately 20% of the aggregate purchase price of the undivided interests sold in the Unit 2 sale and leaseback transactions was provided by the equity investors, with the balance being provided through the issuance of non-recourse debt by the lessor/purchasers. See "Facilities — Palo Verde Station — Liability and Insurance Matters."

The Company has used approximately $210 million of the proceeds from the Unit 2 sale and leaseback transactions to retire short-term obligations, make required preferred stock redemptions and meet other cash requirements, including construction expenditures. The Company intends to use approximately $100 million of the proceeds to redeem certain outstanding first mortgage bonds, and present projections include the investment of up to approximately $118 million in the Company's diversification program. The balance of the proceeds have been and will be used for general corporate purposes, including construction requirements and other cash needs. Pending such uses, the proceeds have been invested in short-term investments. See "Rates and Regulation," "Construction and Financing Programs — Future Financing", "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note I of Notes to Consolidated Financial Statements.

The Company believes that viable rate moderation plans are in the best interests of the Company's shareholders and ratepayers and intends to continue to work with the regulatory authorities having jurisdiction over the Company's electric rates toward the establishment of such plans. Consummation of the Unit 2 sale and leaseback transactions facilitates the Company's ability to implement viable rate moderation plans. As a result of such sale and leaseback transactions, the net present value of the cost of the Company's total capital investment in Palo Verde is reduced, and revenue requirements associated with Unit 2 are leveled and reduced over the term of the Unit 2 leases, when compared to the revenue requirements that would be associated with Unit 2 under traditional rate making assumptions. This is because the assets sold in the transactions will not be included in rate base and ratepayer responsibility for the lease payments on Unit 2 is limited to the extent of the book value of the plant sold and leased back, plus all related taxes. The Company intends to recover the balance of the lease payments, attributable primarily to the gain proceeds on the sale of the Unit, through a return on the investment of proceeds from the transactions. See "Rates and Regulation."

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.

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.

FERC. The Company is subject to regulation by the FERC in certain matters that include rates for wholesale power sales 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.

NRC. The Palo Verde Station is subject to the jurisdiction of the Nuclear Regulatory Commission (the "NRC"), which has authority to issue permits and licenses and to regulate nuclear facilities in order to protect the health and safety of the public from radiation hazards and to conduct environmental reviews pursuant to the National Environmental Policy Act. Before any nuclear power plant can become operational, an operating license from the NRC is required. The NRC has granted facility operating licenses for Unit 1 and Unit 2 for a term of forty years beginning December 31, 1984 and December 9, 1985, respectively. Unit 3 is scheduled to attain commercial operation before year end 1987. See "Construction and Financing Programs — Construction Program — Palo Verde Station" and "Facilities — Palo Verde Station."

Rate Matters

Texas

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, which reversed the dismissal and reinstated the case, remanding it to the trial court for a hearing on the merits of the Company's appeal from the Texas Commission.

In June 1985, the Company filed for a rate increase of approximately $61 million in its Texas service area based on a 1984 test year. In January 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 and made certain accounting adjustments, the combined effect of all of which resulted in a decrease of approximately $14.3 million in non-fuel base rates.

The Company appealed the January 1986 final order (the "reduction order") to state district court in Travis County. In conjunction with its appeal, the Company sought a temporary injunction against enforcement of the reduction order. This request was denied. However, when the Company appealed the order denying the injunction to the state court of appeals, that court granted a stay of implementation of the reduction order while it considered such appeal. On January 21, 1987, the court of appeals upheld the district court's denial of the temporary injunction and ordered the stay to be lifted when the court of appeals loses jurisdiction of the case. The Company filed a motion for rehearing of the January 21 decision, and the stay will remain in effect until that motion is overruled. If the stay is lifted, the reduction order will go into effect. If that occurs, the Company might be ordered to credit the decrease, plus interest, to customers retroactively to the date on which the reduction order would have taken effect absent the stay. The Company would contest such an order. In order to ensure that the financial operations of the Company are unaffected by the retroactive decrease should it occur, the Company recorded in 1986 a provision for a revenue refund.

As part of the reduction order, the Texas Commission ordered the Company to defer all costs 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 established by the Texas Commission. The recovery of these deferred costs will be included in the rate order at the time the capital costs of Unit 1 are included in rate base, subject to the Company establishing that the deferred costs were prudently incurred and necessary. The Company considered Unit 1 to have commenced commercial operation on December 31, 1985, but the Texas Commission established February 24, 1986 as the commercial operation date for Texas rate making purposes. In December 1986, the Company filed a request with the Texas Commission to establish September 22, 1986 as the commercial operation date of Unit 2. The Texas Commission has not yet ruled on the Company's request. Pending consideration by its Texas and New Mexico regulators of the commercial operation date of Unit 2 and the rate making treatment of the Company's investment in Unit 2, the Company has deferred costs and accrued related AFUDC on Unit 2, with respect to the Texas and New Mexico jurisdictional portions of Unit 2, subsequent to September 22, 1986. For information regarding such deferrals and accruals, see Notes B, C and D of Notes to Consolidated Financial Statements.

The Company intends to file with the Texas Commission in the Spring of 1987 for an increase in its annual Texas retail rates. The filing will be premised primarily on full inclusion in rate base of the capital costs of Unit 1, two-thirds of Palo Verde Common Plant and Palo Verde deferred costs and inclusion as cost of service of the Unit 2 lease payments to the extent of the book value of plant sold and leased back, as well as all related taxes. Hearings on the case are expected to begin in July 1987. For planning purposes, the Company is assuming that the requested rate increase will become effective by November 1, 1987, on a phased-in basis. See "Construction and Financing Programs — Future Financing" and "Management's Discussion and Analysis of Financial Condition and Results of Operations."

The Company's 1987 rate case will be the first time that the Texas Commission will consider the Company's requested inclusion in rate base as "plant-in-service" of Palo Verde costs. The Company believes it is likely that the Texas Commission will examine the prudence of construction costs and lease expense related to the Palo Verde Station, as well as the Palo Verde deferred costs (see Notes B and C of Notes to Consolidated Financial Statements) and the possible existence of excess generating capacity. Although there can be no assurance as to what action the Texas Commission may take with respect to determination of the prudence of the Palo Verde construction costs or the possible existence of excess generating capacity, management believes that Palo Verde has been constructed in a prudent manner, that no material excess generating capacity presently exists and that the overall construction costs incurred at Palo Verde qualify for full inclusion in the Company's rate base. Unit 2 was completed at a cost per installed kilowatt 25% below the average for 41 comparable nuclear projects, according to a study prepared by one national investment banking firm. Similarly, a study by an independent consulting firm reported that the period between construction commencement and fuel loading for Unit 1 was roughly one year less than the average for a group of 23 nuclear projects constructed during the same period. Completed cost for Unit 1 was reported to be approximately 12% below the average for that group. See "Construction and Financing Programs — Construction Program — Palo Verde Station."

As part of its 1987 rate case filing, the Company has compiled evidence, including expert testimony from independent consultants, relating to the prudence of the planning, management and construction of Palo Verde. In the opinion of counsel to the Company, based upon the evidence compiled and existing law, facts and circumstances, (i) the Company is entitled to rate relief to recover its costs of providing service plus a return on investment, and should receive such rate relief from the Texas Commission, and (ii) should the Texas Commission disallow recovery of any material portion of the costs incurred at Palo Verde based upon a finding that such costs were imprudently incurred, it is probable that rates designed to recover the Company's investment in Palo Verde and a return thereon would be obtainable through court action. Management would contest through such court action any order involving such a disallowance. See Note B to Notes to Consolidated Financial Statements.

Palo Verde Unit 3 is currently scheduled to commence commercial operation by year end 1987. The Company intends to file with the Texas Commission in early 1988 for an additional increase in its annual Texas rates, premised primarily upon the full inclusion in rate base of the capital costs associated with Unit 3. The Company, however, is presently evaluating the possibility of a leveraged lease in the second half of 1987 of its interest in Unit 3 and one-third of its interest in certain Palo Verde Common Plant, similar to the Unit 2 sale and leaseback transactions consummated in 1986. If such a leveraged lease were done, the Company's rate filing with respect to Unit 3 would be for cost of service on the lease payments and rate base treatment on any remaining ownership interest in Unit 3. See "Construction and Financing Programs — Future Financing."

Notwithstanding the fact that the Company's present plans are to file with the Texas Commission for the rate relief described above, the Company has for some time pursued, and intends to continue to pursue, rate moderation settlements with its Texas regulators, including both the Texas Commission and the local municipalities in the Company's Texas service areas. See "Rate Moderation Plans" below.

On May 30, 1986, the General Counsel of the Texas Commission filed a petition of inquiry requesting the Texas Commission to issue an order requiring the Company to show cause why it had ceased funding the Palo Verde Management and Construction Audit then being conducted by the regulatory commissions of Texas, Arizona, New Mexico and California ("the Four State Audit") and had not made payments for certain other regulatory expenses. The petition further requested rescission of certain portions of the Texas Commission's final order in the Company's 1985 rate case relating to the cost deferrals and AFUDC accruals allowed in that order (see above). The Four State Audit was terminated by the regulatory commissions by September 1986, and the other payments detailed in the General Counsel's petition were made prior to that time. In September 1986, the hearing examiner requested briefs on the General Counsel's request for rescission of the accounting order included in the Texas Commission's rate order. These were filed in September 1986, and no further action has been taken by the hearing examiner. The Company believes the Texas Commission does not have the authority to rescind the accounting order as requested by the General Counsel and will appeal any decision which attempts to take such action.

On July 8, 1986, the Texas Commission filed suit against the Company in Texas state district court alleging the Company breached an agreement to pay the Texas share of the Four State Audit expenses. In conjunction with its suit, the Texas Commission sought a temporary injunction ordering resumption of payments for the Four State Audit pending final disposition of the case. After an evidentiary hearing on the application for temporary injunction, on July 25, 1986, the district court denied the injunction, finding no enforceable agreement on the Company's part to pay for the Four State Audit. No further proceedings have taken place in the case. The Company will defend against any further proceedings.

During 1986 and the first quarter of 1987, the Company filed three requests with the Texas Commission to refund sums over-recovered through its fixed fuel factor. The three requests totaled $22.6 million. The over-recovery resulted from lower natural gas prices and the availability of economy energy purchases from other utilities. In conjunction with one of the requests, the Company also sought authorization to implement a lower fixed fuel factor. The Texas Commission approved the lower factor on an interim basis in November 1986. The Texas State Agencies, which unsuccessfully attempted to intervene in one of the fuel refund proceedings, has filed an appeal with the state district court in Travis County contesting the Texas Commission's order approving the refund. While the Company is named as a party to the appeal, the issues involved relate to the allocation and distribution of the refund and the legality of the denial of intervenor status to the Texas State Agencies and the case should not materially affect the Company in any manner.

New Mexico

The Company has, as part of its continuing efforts to reach viable rate moderation plans for its service areas, entered into a stipulation with certain New Mexico jurisdictional parties, including the staff of the New Mexico Commission and various New Mexico customer groups, which provides for a settlement regarding rate treatment of the Company's investment in Palo Verde. The stipulation, which was filed with the New Mexico Commission on March 9, 1987, provides for (i) continued full inclusion in the Company's rate base of the capital costs of Palo Verde Unit 1 and one-third of Palo Verde Common Plant and inclusion in rate base of certain transmission facilities, (ii) recovery of the New Mexico portion of equity AFUDC attributable to Unit 3 in rates as cost of service, amortized over a period ending December 31, 1994, subject to acceleration based upon recoupment of the cost of service deferrals described in clause (iii) next following, (iii) increases in rates of 3% on a total cents per kilowatt hour basis in 1987, 3% in base rates no sooner than one year after the 1987 increase and an additional 3% in base rates no sooner than one year after the second 3% increase, with any deficiency in revenue requirements resulting from this rate path being deferred for collection in later years (base rates to remain constant after the third 3% increase until the earlier of December 31, 1994 or the full recoupment of such deferrals and the New Mexico portion of equity AFUDC attributable to Unit 3), (iv) subject to the New Mexico Commission finding that the lease payments incurred by the Company in the Unit 2 sale and leaseback transactions were prudently incurred, recovery in rates of such lease payments to the extent of the book value of plant sold and leased back in those transactions, as well as all related taxes, (v) agreement by the Company that, except for the New Mexico portion of equity AFUDC attributable to Unit 3, neither the capital costs of Palo Verde Unit 3 and one-third of Palo Verde Common Plant and a proportionate share of certain Palo Verde transmission facilities nor any Unit 3 operating expenses will at any time be included in the Company's rate base or receive any cost of service treatment insofar as the New Mexico jurisdiction is concerned, (vi) resolution, insofar as the Company is concerned, of any possible issue relating to the prudence of the planning, management and construction of Palo Verde and (vii) settlement of any possible issue of excess generating capacity through 1993. The Company, based upon present planning analyses, does not expect to have excess generating capacity.

The stipulation provides that any portion of cost of service deferrals not recouped prior to December 31, 1994 will not be recovered through rates in New Mexico. Based upon present planning analyses, the Company expects to recoup in full such cost of service deferrals prior to such date.

The stipulation is subject to the approval of the New Mexico Commission, and hearings are expected to commence in April 1987.

The Company filed a formal rate case with the New Mexico Commission in January 1987 for a 21.66% increase in annual New Mexico retail rates (an increase of approximately $13.9 million net of fuel savings). The rate case is primarily premised upon the continued full inclusion in the Company's rate base of the capital costs of Palo Verde Unit 1 and one-third of Palo Verde Common Plant and inclusion in cost of service of the operating and maintenance expenses for Units 1 and 2 and the lease payments on Unit 2 to the extent of the book value of the plant sold and leased back in the Unit 2 sale and leaseback transactions, as well as all related taxes. The New Mexico Commission suspended the effectiveness of the requested increase for the statutory time period to December 1987.

The January rate case will remain filed before the New Mexico Commission pending the Commission's approval of the stipulation discussed above. If the stipulation is approved by the New Mexico Commission, the Company will attempt to settle the remaining cost of service issues and, if settlement can be reached regarding those issues, the new rates provided for by the stipulation could go into effect as early as summer 1987. The rate path established by the stipulation would provide for an increase of approximately 20% in New Mexico base rates over the three-year period specified in the stipulation.

If the rate settlement reflected in the New Mexico stipulation discussed above is implemented in New Mexico, the Company expects to enter into additional wholesale power sales agreements for the sale of the energy theretofore attributable to the New Mexico jurisdictional portion of Unit 3, the rates for which thereafter would be subject to the regulation of the FERC. See Note B of Notes to Consolidated Financial Statements.

FERC

The Company's rates for wholesale power sales make up a significant portion of the Company's operating revenues. During 1986 and 1985, approximately 12% and 7%, respectively, of the Company's electric operating revenues resulted from such sales.

In March 1986, the Company filed increased rates for service to three wholesale customers, IID, TNP and RGEC. The requested increase amounted to approximately $32 million utilizing a forecasted 1986 test period. In May 1986, the Company was allowed to implement a portion of the increased rates under suspension. The Company has subsequently entered into settlement agreements with each of these customers. Applications for approval of the settlements with IID and RGEC are pending before the FERC, and application for approval of the TNP settlement is expected to be filed with the FERC in the near future. The settlements will provide an increase in rates of $21 million, of which $11.8 million was recorded in 1986.

The settlement with IID is based upon a long-term firm power sales agreement providing for the sale of 100 megawatts of firm capacity to IID beginning in 1987 and continuing through April 2002. In addition, the agreement calls for contingent capacity of 50 megawatts to be made available to IID beginning in 1987 and continuing through April 2002. The settlement agreement with IID settles any possible issue of the prudence of the construction costs of PVNGS and of excess generating capacity. As a condition to the settlement, the Company is required to secure certain long-term back-up transmission capacity, which the Company believes can and will be secured.

The settlement agreement with TNP is based upon a revised firm power sales agreement with TNP. As part of the settlement of the rate increase request, the Company and TNP settled an arbitration proceeding concerning a dispute between the parties with respect to the contracted level of reserve demand under the Company's prior sales agreement with TNP. The revised firm power sales agreement with TNP provides for firm power sales to TNP ranging from 43 megawatts to 79 megawatts, beginning in 1987 and continuing through 2002, with negotiated demand charge rates for such power.

The Company settled its request to increase rates to RGEC by entering into a one-year agreement providing for rates from October 1986 through October 1987 and resulting in an increase in the Company's base revenues from service to RGEC of approximately $880,000 over current rates.

Rate Moderation Plans

The Company believes that viable rate moderation plans are in the best interests of the Company's shareholders and ratepayers and intends to continue to work with the regulatory authorities having jurisdiction over the Company's rates toward the establishment of such plans. In the Company's view, viable rate moderation plans, such as the March 1987 stipulation in New Mexico discussed above, are those which maintain traditional utility pricing objectives of rate continuity, without adverse effects on ratepayers, yet providing a level of operating revenues that, in conjunction with other revenues, enable the Company to recover its expenses of operation plus earn a fair return on shareholder investment.

Consummation of the Unit 2 sale and leaseback transactions facilitates the Company's ability to implement rate moderation plans. As a result of the Unit 2 transactions, the net present value of the cost of the Company's total capital investment in Palo Verde is reduced, and revenue requirements associated with Unit 2 are leveled and reduced over the term of the Unit 2 leases, when compared to the revenue requirements that would be associated with Unit 2 under traditional rate making assumptions. This is because the assets sold in the transaction will not be included in rate base and ratepayer responsibility for the lease payments on Unit 2 is limited to the extent of the book value of the Unit, plus all related taxes. The Company intends to recover the balance of the lease payments, attributable primarily to the gain proceeds on the sale of the Unit, through a return on the investment of proceeds from the transaction.

Diversification Program

On November 25, 1986, the Company filed an application with the New Mexico Commission for regulatory authorization to implement a diversification program. The Company's present plans include the investment of up to approximately $118 million of the Unit 2 sale and leaseback proceeds in such diversification program. The investments are planned to be made through a newly-formed, wholly-owned subsidiary of the Company, which would not be subject to regulation as a utility. The President of the investment subsidiary is Billye E. Bostic, who served as Executive Vice President and Chief Financial Officer of the Company until December 1986 when he assumed his responsibilities for the subsidiary.

At the present time, the investment subsidiary has identified and entered into negotiations (some of which are preliminary in nature) for various types of investments, the aggregate capital costs of which are approximately $90 million. The investments include common and preferred stock investments and secured debt transactions. The principal investment involves a proposed $60 million purchase of floating rate exchangeable preferred stock to be issued by a federal savings and loan association, an affiliate of which was an equity investor in the Unit 2 sale and leaseback transactions. For information regarding certain relationships between affiliates of the federal savings and loan association and the Company, see Note I of Notes to Consolidated Financial Statements.

Hearings before the New Mexico Commission regarding the presently identified investments were held in February 1987, and the Commission authorized those investments in mid-March 1987. Hearings regarding the balance of the Company's diversification program are expected to commence in the near future.

Fuel Cost Adjustment Provisions

Tariffs applicable to all of the Company's sales contain fuel cost adjustment provisions. The Company's Texas retail customers are presently being billed at a fixed fuel factor approved by the Texas Commission (see "Rate Matters — Texas"). This fuel factor will remain in effect until the earlier of the Company's next general rate case or Commission ordered fuel reconciliation.

By agreement approved by the New Mexico Commission, the Company's New Mexico retail customers are presently being billed under a fixed fuel factor similar to Texas. The current fixed fuel factor (effective April 1986) was based on projected 1986 fuel costs, including Palo Verde nuclear fuel costs. In January 1987, the Company requested that the factor be lowered due to a material over collection of allowable fuel costs. The application is currently pending. The March 1987 stipulation (see "Rate Matters — New Mexico") continues the fixed fuel factor procedure through the phase-in period defined in the stipulation and provides that each factor will remain in effect for one year 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 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 1987 through 1990 set forth in the table below are approximately $245 million, consisting of approximately $215 million cash and approximately $30 million in related AFUDC, net of deferred tax. The estimated costs were prepared as of February 25, 1987. 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.

	1987	1988	1989	1990
		(In thousands)		
Production:				
Palo Verde Station(1)	$ 22,300	$ 200	$ 0	$ 0
Other	10,700	9,300	11,500	10,200
Transmission:				
Palo Verde Station	500	11,800	0	0
Other	20,900	18,900	15,200	1,800
Distribution	15,400	19,600	16,500	17,200
General Plant	3,900	3,300	2,800	3,000
AFUDC(2):				
Palo Verde Station	22,000	1,500	1,400	0
Other	3,000	4,200	4,300	1,100
Deferred Tax on AFUDC(3)	(5,100)	(1,000)	(1,000)	(200)
Total	$ 93,600	$ 67,800	$50,700	$33,100

(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 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 purposes.

Net utility plant at December 31, 1981 was $805,768,000. Gross additions to plant, including construction work in progress, for the five years ended December 31, 1986 totaled $1,124,446,000 (the largest portion of which was $871,913,000 for the nuclear plant at the Palo Verde Station). Net utility plant at December 31, 1986 was $1,387,859,000 which included the effect of the Unit 2 sale and leaseback transactions. (Includes capitalized nuclear fuel of approximately $40,937,000 leased from the nuclear fuel trust. See "Energy Sources — Nuclear Fuel.")

Palo Verde Station. The Company has a 15.8% 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 (owned as to Units 1 and 3, and leased as to Unit 2). 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 the Units 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, 1986, Unit 3 was approximately 99.9% complete. Fuel loading of Unit 3 is scheduled to begin in March 1987, and the Unit is scheduled to attain commercial operation before year end 1987. See "Facilities — Palo Verde Station."

The table below sets forth the costs incurred by the Company through December 31, 1986 with respect to the construction of Palo Verde (including the cost of start-up and testing and the Company's share of the cost of related switchyard and transmission facilities), and the Company's estimate of the cumulative cost of construction through the completion of Palo Verde. 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 were prepared as of February 25, 1987.

	Actual Costs Through December 31, 1986	Estimated Cumulative Costs Through 1987	Estimated Cumulative Costs Through 1988
		(In thousands)	
Nuclear Plant	$ 944,000	$ 966,300	$ 966,500
Related AFUDC	477,600	498,000	498,000
Transmission Lines & Switchyard	23,700	24,200	36,000
Related AFUDC	8,500	10,100	11,600
Deferred Tax on AFUDC	(97,900)	(102,400)	(102,700)
Total	$1,355,900	$1,396,200	$1,409,400

The above table includes approximately $448.5 million in book value of the undivided interests involved in those Unit 2 sale and leaseback transactions in which the related leases are accounted for as operating leases. Such book value no longer appears as an asset of the Company. See Note I of Notes to Consolidated Financial Statements.

Future Financing

Of the approximately $684.4 million received from the Unit 2 sale and leaseback transactions, the Company has used approximately $210 million to retire short-term obligations, make required preferred stock redemptions and meet other cash requirements, including construction expenditures. The Company plans to use $100 million of the proceeds to redeem in 1987 at their principal amount plus accrued interest its $40 million First Mortgage Bonds, 16.35% Series due 1991 and its $60 million First Mortgage Bonds, 16.20% Series due 2012. Up to approximately $118 million of the proceeds are expected to be invested in connection with the Company's diversification program. See "Rates and Regulation — Diversification Program." The balance of the proceeds have been and will be used for general corporate purposes, including construction requirements and other cash needs as described below. Pending such uses, the proceeds have been invested in short-term investments.

The Company estimates that its cash requirements during 1987 for construction expenditures (including nuclear fuel acquisition payments), mandatory preferred stock redemptions, scheduled debt repayments and dividends aggregate $287 million. The Company plans to meet these requirements through the use of internally generated funds, based upon adequate and timely rate relief in Texas and New Mexico, and through use of a portion of the proceeds from the Unit 2 sale and leaseback transactions.

Cash requirements for the 1988-1990 time period for construction (including nuclear fuel acquisition payments), mandatory preferred stock redemptions, long-term debt maturities and dividends are expected to aggregate approximately $617 million. The Company plans to meet these requirements during 1988 through the use of internally generated funds, based upon adequate and timely rate relief in Texas and New Mexico, and through use of a portion of the proceeds from the Unit 2 sale and leaseback transactions. Based upon present planning analyses, the Company does not expect to require external financing until 1989.

The above estimates are based upon increases in annual retail rates in Texas and New Mexico (see "Rates and Regulation — Rate Matters") and upon utilization of proceeds from the Unit 2 sale and leaseback transactions in connection with the planned diversification program and otherwise so as to earn an adequate return on the investment of such proceeds. Management believes that phased-in increases in rates may be the most likely form of rate relief to occur in the near future, and the above estimates reflect phase-ins of the requested rate relief. For phased-in increases in rate relief to be adequate, the rate relief must be comprised of both an adequate level of cash rate relief and a phase-in plan which provides for the deferral and subsequent recovery of costs and a return on investment not currently recovered in cash rate relief.

Management believes that the Company is entitled to and will obtain adequate and timely rate relief. However, neither the adequacy nor the timing of rate relief can be predicted with certainty. Without such rate relief and a sufficient investment return on Unit 2 sale and leaseback proceeds, the Company's future results of operations and/or cash flow from operations would be adversely affected, and the Company's ability to obtain at satisfactory costs the additional external financing that would be required and/or continue to pay dividends on common stock at current levels could be adversely affected. The Company, without such rate relief and investment return or sufficient external financing, might have to consider the elimination or reduction of operating expenses, which could ultimately have an adverse effect upon customer service. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note B of Notes to Consolidated Financial Statements.

The Company is considering a leveraged lease transaction in the second half of 1987 of all or part of its interest in Unit 3 and one-third of its interest in certain Palo Verde Common Plant and has begun soliciting institutional equity investors for such a transaction. The estimated fair market value of the Company's entire interest in Unit 3 and such Common Plant is approximately $700 million. If such a transaction were consummated, the Company would not require any external financing during the 1989-1990 time period and would plan to use a portion of the proceeds from such a transaction for, among other things, the purpose of reducing its capital structure through the redemption or purchase of outstanding long-term debt and the possible repurchase of a portion of outstanding equity. There is no assurance that the Company will consummate such a sale and leaseback transaction.

The terms of external financing by the Company are affected by rate relief (as stated above) and 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, First and Second Mortgage Indentures and in the Unit 2 sale and leaseback participation agreements 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'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 8.375% on additional shares of preferred stock, the most restrictive of said tests, (iii) above, would have permitted the issuance of approximately $272,800,000 in preferred stock at December 31, 1986.

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, 1986, the Company would have been permitted to issue approximately $60,100,000 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, 1986, unfunded net additions totaled $327,200,000 which was sufficient to permit the issuance of $196,300,000 principal amount of new bonds.

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, 1986, unfunded net additions totaled $156,700,000 which was sufficient to permit the issuance of $62,700,000 principal amount of additional second mortgage bonds.

Each of the participation agreements executed in connection with the Unit 2 sale and leaseback transactions contains provisions which restrict the incurrence of additional debt by the Company and its subsidiaries unless certain debt to capitalization tests and coverage ratios are met. Restrictions under such participation agreement provisions limit long-term debt issuable to $164,200,000 at December 31, 1986.

Short-Term Obligations

At December 31, 1986, the Company had no short-term obligations outstanding, however, the Company maintained informal lines of credit which totaled approximately $157,300,000 at December 31, 1986 and which provide for the payment of lines of credit fees of various negotiated amounts.

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, 1987, 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 J of Notes to Consolidated Financial Statements.

Facilities

General

As described below, the Company currently has a net generating capacity of 1,303 MW, consisting of 246 MW at Rio Grande, 478 MW at Newman, 69 MW at Copper, an entitlement of 110 MW from Four Corners and an entitlement of 400 MW from Palo Verde Units 1 and 2.

The Company's all-time total system peak load is 938 MW which was recorded in August 1986, as compared with the previous total system peak load of 877 MW recorded in August 1985. The peak of 938 MW includes 783 MW of native system load and 155 MW of contract off-system load. The all-time native system peak of 790 MW was recorded on August 21, 1986.

The Company periodically makes long-range planning 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 1987-1996 time period is approximately 3.2%.

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 212 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 — Natural Gas.")

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 (which is 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 Navajo Indian Tribe (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 the following paragraphs under this caption). 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 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.

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 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, are liable for the payment of these 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). APS, the Operating Agent for Four Corners, is uncertain whether the tax waiver provisions in the Four Corners plant site lease agreement would allow the participants to prevail in nullifying the 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 that 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.

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 is being 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 initially 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 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 will be recoverable directly through fuel adjustment clauses or as a recovery of operating expenses in subsequent rate proceedings. See "Rates and Regulation — Fuel Cost Adjustment Provisions."

The participants in Four Corners are 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 the water rights of the San Juan River Stream System in New Mexico, which, among other things, supplies the water used at Four Corners. No trial date has been set in this matter. An agreement reached with the Tribe in 1985 provides that if the Four Corners Plant loses a portion of its rights in the adjudication, the Tribe will provide sufficient water from its allocation to offset the loss.

Palo Verde Station

For information regarding the Company's interest in the Palo Verde Station, see "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."

Both groundwater and surface water in areas of Arizona 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, APS, as Project Manager for Palo Verde, has entered into contracts with certain municipalities granting the right to purchase 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 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. This action was dismissed in November 1985. That dismissal has been appealed to the United States Court of Appeals for the Ninth Circuit. APS 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. This 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. APS and certain Palo Verde participants, including the Company, have cross-appealed. On December 17, 1986, the consolidated appeals and cross-appeals were transferred to the Arizona Supreme Court, and oral argument was held on February 20, 1987.

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 contract violates the laws and public policy of Arizona. APS was joined as an indispensable party. On July 29, 1986, judgment was entered declaring the primary effluent contract valid and enforceable. The Adverse Parties appealed, and a cross-appeal was filed by APS.

A summons served on APS in early 1986 required all water claimants in the Lower Gila River Watershed in Arizona to assert any claims to water on or before January 20, 1987, in an action pending in Maricopa County, Superior Court. Palo Verde is located within the geographic area subject to the summons, and the right of the Palo Verde participants to the use of groundwater and effluent at Palo Verde is potentially at issue in this action. APS, as Project Manager for Palo Verde, filed claims that dispute the Court's jurisdiction over the Palo Verde participants' groundwater rights and their contractual rights to effluent relating to Palo Verde, and alternatively, seek confirmation of such rights. No trial date has been set in this matter.

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

APS, as Project Manager for Palo Verde, has advised the Company that the partial completion of the Central Arizona Project has augmented existing water supplies in certain parts of Arizona. APS has been granted an allocation of this water by the Secretary of the Interior. Nonetheless, 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 status of the Palo Verde Station as a highly visible large water consumer, in which a number of utilities from outside the State of Arizona participate, may attract 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.

In connection with the NRC's Antitrust Operating License Review for Palo Verde Unit 3, Plains Electric Generation and Transmission Cooperative, Inc. ("Plains") filed comments with the NRC in

November 1986 alleging anticompetitive conduct by the Company and requesting that the NRC, after hearing, impose conditions on the operating license for Palo Verde Unit 3. Plains has asserted that significant changes have occurred since the last NRC antitrust review that would warrant the NRC to impose such conditions. In particular, Plains asserts that the Company has not allowed Plains to utilize its transmission system to its full capability and has not allowed Plains to wheel across the Company's transmission system. The Company has filed a response with the NRC and has denied Plains' allegations regarding anticompetitive activity. No delay in the granting of the operating license for Palo Verde Unit 3 is antiticipated as a result of Plains' allegations.

Liability and Insurance Matters. The Palo Verde participants currently have insured against public liability claims resulting from nuclear energy hazards to the full limit ($700 million as of March 2, 1987) of liability under Federal law (such law being commonly referred to as the "Price-Anderson Act"). The maximum amount of insurance available from private carriers ($160 million) has been purchased. The balance of the coverage ($540 million as of March 2, 1987) is provided through a secondary financial protection program using an industry-wide retrospective rating plan, under which the Palo Verde participants could be assessed deferred premium charges of up to $5 million (of which the Company's share would be 15.8%) for each Palo Verde unit licensed by the NRC in the event the total liability arising from any nuclear incident involving any licensed facility in the nation exceeds $160 million. 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 (the Company's share of which would be 15.8%) per licensed unit for all incidents.

The Palo Verde participants maintain "all risk" (including nuclear hazards) insurance for nuclear property damage to, and decontamination of, property at Palo Verde in the aggregate amount of $1.230 billion (as of January 15, 1987), a substantial portion of which must first be applied to decontamination. 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 is currently insured, after a 26-week deductible period, for approximately $310,000 per week for Unit 1 and approximately $300,000 per week for Unit 2 for 52 weeks and up to 50% of the respective amounts for an additional 52 weeks. After Unit 3 is placed in service, the Company can increase the coverage amounts to up to $787,500 per week per unit. In the event that an incident affects more than one unit, the coverage is reduced by 20% for each additional affected unit (i.e., two units simultaneously out of service result in 80% of single unit recovery for the second unit, three units simultaneously out of service result in 60% of single unit recovery for the third unit).

In addition to the above-described policies of insurance, the Palo Verde participants are parties to an indemnity agreement with the NRC containing an undertaking by the NRC to indemnify the Palo Verde Participants and any other person who may be legally liable from public liability arising from nuclear incidents. The maximum aggregate indemnity for each nuclear incident is $500 million less the amount by which the amount of required financial protection exceeds $60 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.

Under the Price-Anderson Act as currently in effect, the authority of the NRC to enter into new indemnity agreements is limited to those nuclear facilities which receive or will receive construction permits prior to August 1, 1987. The expiration of the NRC's authority to execute indemnity agreements in respect of facilities which receive construction permits after August 1, 1987, if not modified by Congress, will have no effect upon the financial protection and indemnity agreements for plants now licensed for operation or 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 proposals 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. Bills to extend the expiring provisions and to amend or eliminate other provisions of the Price-Anderson Act have been offered in both the United States Senate and House of Representatives. Certain Senate and

House Committees of the 99th Congress reported out bills to amend the Price-Anderson Act that would have increased the limit on liability to amounts as high as $6.6 billion per nuclear incident (or higher amounts in the future). In the current 100th Congress, a bill has been introduced in the House of Representatives that would amend the Price-Anderson Act by, among other things, increasing the limitation on liability to as high as $7 billion per nuclear incident (or higher amounts in the future). If this bill or a similar bill is enacted into law, funding required to meet the increased limit on liability would be provided through a more than ten-fold increase in deferred premium charges.

Certain of the bills introduced in the 99th Congress and the bill introduced in the current 100th Congress included some provisions which, if enacted, could permit one or more equity investors in the Unit 2 sale and leaseback transactions to declare a "deemed loss event." The bill introduced in the 100th Congress includes a provision to the effect that a lessor in a bona fide sale and leaseback of a nuclear generating unit will not be liable by reason of its interest as lessor for any legal liability arising from a nuclear incident, unless such lessor is in actual possession and control of such facility at the time of the incident. Inclusion of such language in any final legislation enacted would make declaration of a deemed loss event less likely. The Company believes the likelihood that any amendment to the Price-Anderson Act will include provisions permitting such an equity investor to declare a deemed loss event is remote. Whether Congress will act to amend the Price-Anderson Act cannot be predicted with certainty. Failure by Congress to amend or extend certain provisions of the Price-Anderson Act will not constitute a deemed loss event under any of the leases involved in the Unit 2 sale and leaseback transactions. In the event legislation permitting one or more equity investors to declare a deemed loss event is enacted into law, the reaction of the equity investors to such enactment cannot be predicted by the Company. If a deemed loss event were declared, the Company would be obligated to pay the related equity investor an amount in cash which could, due primarily to certain tax consequences, exceed such equity investor's unrecovered equity investment in respect of its undivided interest in Unit 2. Upon such payment and assumption of the debt portion of the purchase price of the undivided interest, the undivided interest will be transferred to the Company. The equity investors provided approximately 20% of the purchase price of the undivided interests, with the balance of the purchase price being provided through non-recourse debt issued by the lessor/purchasers. See "Palo Verde Unit 2 Sale and Leaseback Transactions" under "Company Conditions."

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 Four Corners Plant 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 operations at Four Corners. APS, as Operating Agent at Four Corners, obtained variances relating to the emission of nitrogen oxides for Units 4 and 5 at Four Corners in 1980, based on a finding by state authorities that emissions from the Plant did not violate air quality standards and that there was no reasonably available technology that would allow the Plant to meet the existing emissions limitation. Further variances relating to the emission of nitrogen oxides were issued for Units 4 and 5 in 1983 and 1986. The most recent variance, which will expire on May 31, 1987, was granted subject to the condition that APS conduct a pilot-scale combustion test program with new burners designed to reduce emissions of nitrogen oxides to determine whether it is technically feasible to bring the Units into compliance with the existing emissions limitation without adverse operational impacts. The test program and evaluation period are expected to be completed by August 1987, after which time a determination will be made as to whether the burners will be required. APS, as Operating Agent, intends to apply for an extension of the most recent variance beyond May 31, 1987 so that the test program and evaluation period may be completed.

The Federal Clean Air Act Amendments of 1977 may require installation of "the best available retrofit technology" on sources that impact visibility in certain federally protected areas where 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 applicable regulations have not been finalized, and, as a result, the full significance and cost of the visibility provisions to the Four Corners Plant cannot be predicted.

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

Since 1982, the Company's energy mix has generally consisted of natural gas, coal, and purchased power and in 1986, also uranium. The following table lists the percentage contribution of coal, gas, uranium, and purchased power to the total energy mix of the Company and the average cost to the Company in cents per KWH.

	Coal		Gas		Uranium		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
1982	16%	.70¢	59%	4.00¢	—%	—¢	25%	2.80¢
1983	18	.77	44	4.23	—	—	38	2.30
1984	16	.83	46	4.00	—	—	38	2.64
1985	11	1.02	28	3.81	—	—	61	2.80
1986	13	1.01	30	2.36	7	.98	50*	2.30

* Pending rate making treatment of the Company's investment in Palo Verde as described in "Rates and Regulation", the Company is including under purchased power the major portion of energy generated by Palo Verde Units 1 and 2.

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 — Fuel Cost Adjustment Provisions."

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. The Company is now in the fifth year (1987) and expects to realize the required plan goals which call for continuing programs in the areas of customer assistance, public information and operating efficiency. The Company's annual report covering the fourth year of the program was filed with FERC in January, 1987.

In 1986, the FERC issued new regulations 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. The Company's supplier of interstate gas (which is under FERC jurisdiction) has chosen to participate in the FERC program and will begin transportation under FERC Order 436 in 1987. In addition, FERC is considering allowing pipelines to bill customers directly for the money paid to producers to settle take-or-pay contract penalties incurred by the pipelines that began transporting spot natural gas in 1986. FERC has scheduled a hearing on this subject and the uncertainties involved make it difficult to assess the impact on the Company. 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 1987. 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 suppliers, it is expected that any changes in the near term regulatory framework will have a minimal impact on the Company's fuel costs.

Natural Gas

The Company is supplied with natural gas from both interstate and intrastate pipeline systems. The interstate natural gas is supplied pursuant to a contract with El Paso Natural Gas Company which is set to expire at the end of 1987. Arrangements are underway to renegotiate this contract prior to its expiration date.

The majority of the natural gas requirements for Rio Grande Station are being supplied by El Paso Gas Marketing, a subsidiary of El Paso Natural Gas Company, with less expensive spot natural gas. In 1986, an average spot/contract mix of 70/30 was provided considerably reducing the Company's operating costs.

The intrastate natural gas requirements at Copper and Newman are supplied pursuant to the intrastate contract with El Paso Hydrocarbons via subsidiary El Paso Gas Transportation Company. This contract was amended in 1986, lowering the Company's take-or-pay requirements, resulting in greater flexibility and allowing maximization of inexpensive economy purchased power and generation from Palo Verde. In addition, interstate natural gas can be supplied to Newman Units 1, 2, and 3. This allows for a back up 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 1986, the Company experienced no significant supply curtailments and does not expect any significant curtailments during 1987 with respect to either interstate or intrastate gas supplies.

Coal

The Company believes that sufficient reserves of low sulfur coal (the sulfur content of which is currently running 0.8%) 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 the existing contract were relatively steady, although applicable contract clauses permit escalations under certain conditions. In addition, major price increases from time to time result from contract renegotiation. The Company believes, but has no assurance, that any increased costs incurred as a result of contract renegotiation will be recoverable either through fuel adjustment clauses or as a recovery of operating expenses in subsequent rate proceedings. See "Rates and Regulation — Fuel Cost Adjustment Provisions."

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. 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 under a conversion service contract with Allied Corporation will meet Palo Verde's operational requirements for uranium hexafluoride until 1990. Existing contracts for fabrication services with Combustion Engineering, Inc. will provide fuel assembly fabrication services for each of the Palo Verde units for at least the first ten years of operation and approximately the next twelve years of operation of each unit, if options are exercised.

The participants in Palo Verde, including the Company, have an enrichment services contract with DOE that obligates 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 the utility services contract used by DOE in its negotiations with utilities, including the contract with 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.

Pursuant to the Nuclear Waste Policy Act of 1982 (the "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. The NRC, pursuant to the Act, also requires all operators of nuclear power reactors to enter into spent fuel disposal contracts with DOE. APS, as 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 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, 1991. 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 purchasing 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 heat purchase option as the basis for payment for the first fuel loads for Palo Verde Units 1 and 2, and presently intends to elect the heat purchase option as the basis for payment for future fuel loadings. Quarterly heat payments at the established prices began in the first quarter of 1986 for Palo Verde Station Unit 1 and in the first quarter of 1987 for Unit 2. At December 31, 1986, the aggregate investment of the trust in such nuclear fuel and related materials was approximately $93,100,000, including approximately $50,100,000 for fuel loaded at Palo Verde Units 1 and 2.

Executive Officers of the Registrant

Name	Age	Current Position and Business Experience
Evern R. Wall	54	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.
Charles Mais	55	Senior Vice President since June 1986; Vice President since December 1978.
Ignacio R. Troncoso	40	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.	48	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	45	Vice President since May 1984 and Treasurer and Chief Financial Officer since December 1986 and Controller from May 1978 to December 1986.
William W. Royer	42	Vice President since December 1985, Treasurer from December 1983 to December 1986 and General Counsel since March 1981.
Joseph E. Wasiak	55	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	55	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.
Robert L. Corbin	56	Vice President since December 1986; Assistant Vice President and Assistant Secretary from May 1984 to December 1986 and for more than 5 years prior hereto served as Assistant Treasurer and Assistant Secretary in various managerial and supervisory capacities with the Company.
Theta S. Fields	61	Secretary since 1977 and Assistant to the President since June 1986.
Billye E. Bostic	56	President of Pasotex, Inc., the Company's new investment subsidiary, since December 1986, and Vice Chairman of the Board of Directors and Vice President of Franklin Land & Resources, Inc., a subsidiary of the Company; Executive Vice President of the Company from May 1982 until December 1986; Senior Vice President of the Company from December 1978 to May 1982.

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 Activities

FL&R, 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. FL&R's major projects include the operation of the Westin Paso Del Norte Hotel, the Cortez Office Building (Cortez), the Cortez Parking Building (Annex) and the Mills Building in downtown El Paso. FL&R has entered into long-term leases as the lessee of the land underneath the Westin Paso Del Norte and the Cortez. The Mills Building is leased to the Company.

The acquisition and construction costs of the Cortez and the Annex aggregated approximately $14,900,000. The Cortez (with approximately 91,000 rentable square feet) was placed in service in May 1985 and the Annex was placed in service in January 1986. At December 31, 1986, the Cortez was 79% leased and the ground floor of the Annex was occupied by a major savings bank. FL&R intends to form a limited partnership for the ownership and operation of the Cortez and the Annex, with FL&R serving as general partner and receiving fifty percent of the partnership gains and losses, subject to certain special allocations among partners.

FL&R acquired additional land adjacent to the Westin Paso Del Norte Hotel and constructed 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 was approximately $60,000,000. FL&R 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. Westin Hotel Company has entered into an agreement to manage the hotel. The Westin Paso Del Norte consists 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 FL&R. (See Note H to Notes to Consolidated Financial Statements.) FL&R has also invested in certain partnerships for the leasing of assets to third parties, preferred stocks, and real estate, primarily located in downtown El Paso.

Operating Statistics

	December 31, 1986	1985	1984
Operating revenues (In thousands):			
Residential	$ 103,428	$ 108,289	$ 106,052
Commercial and industrial, small	98,543	104,679	102,226
Commercial and industrial, large	37,821	45,325	48,619
Sales to public authorities	50,872	53,993	55,149
Sales for resale	38,611	24,981	15,780
Provision for refund	(13,315)	—	—
Other	2,149	2,324	1,189
Total operating revenues	$ 318,109	$ 339,591	$ 329,015
Number of customers (End of year):			
Residential	198,002	191,248	185,062
Commercial and industrial, small	20,115	19,349	18,650
Commercial and industrial, large	39	41	40
Other	2,309	2,263	2,151
Total	220,465	212,901	205,903
Average annual use and revenue per residential customer:			
KWH	5,719	5,735	5,755
Revenue	$ 530.86	$ 575.37	$ 582.94
Average revenue per KWH:			
Residential	9.28¢	10.03¢	10.13¢
Commercial and industrial, small	7.78	8.70	8.89
Commercial and industrial, large	5.74	6.51	6.56
Energy supplied, net, KWH (In thousands):			
Generated	2,422,514	1,823,946	2,705,213
Purchased and interchanged	2,437,875	2,838,904	1,643,257
Total	4,860,389	4,662,850	4,348,470
Energy sales, KWH (In thousands):			
Residential	1,114,177	1,079,432	1,046,933
Commercial and industrial, small	1,267,129	1,202,938	1,149,471
Commercial and industrial, large	658,521	696,662	741,134
Sales to public authorities	809,619	786,983	773,886
Sales for resale	641,858	511,517	324,354
Total sales	4,491,304	4,277,532	4,035,778
Losses and company use	369,085	385,318	312,692
Total	4,860,389	4,662,850	4,348,470
Native system peak load, KW	790,000	778,000	776,000
Net generating capacity for peak, KW	1,103,000	989,000	989,000
Load factor	70.2%	68.4%	63.8%

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 H 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 regulation 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 1985 and 1986 indicated below, were as follows:

	Sale Price		
	High	Low	Dividends
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
1986			
First Quarter	18	15⅛	0.38
Second Quarter	18½	13½	0.38
Third Quarter	19¾	15⅞	0.38
Fourth Quarter	19¼	16¼	0.38

At February 27, 1987, there were 49,733 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, 1986, the retained earnings available for dividends on the common stock under the most restrictive of those provisions was approximately $195,897,000.

The Company has paid quarterly dividends on its common stock without interruption since distribution of the common stock to the public in 1947 (39 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 and timely rate relief, earnings, cash flow, the financial condition of the Company and other factors. See "Company Conditions," "Construction and Financing Programs — Future Financing" and Note B to Notes to Consolidated Financial Statements.

Item 6. Selected Financial Data

As of and for the years ended December 31:

	1986	1985	1984	1983	1982
		(In thousands except per share data)			
Operating revenues	$ 318,109	$ 339,591	$ 329,015	$ 302,443	$ 271,048
Net income	95,614	113,071	108,286	87,261	70,888
Net income per share of common stock	2.32	2.88	2.88	2.48	2.30
Dividends declared per share of common stock	1.52	1.49	1.43	1.37	1.31
Total assets	2,194,418	1,919,060	1,690,109	1,393,283	1,132,626
Long-term, financing and capital lease obligations and preferred stock — redemption required	947,631	971,228	803,577	591,563	463,949

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

Liquidity and Capital Resources

The ability of the Company to generate cash ("liquidity") is dependent upon adequate and timely rate relief; utilization of proceeds from the Unit 2 sale and leaseback transactions for redefinition of the Company's capital structure and investment of such proceeds so as to earn an adequate return on such investment; and external financing. See "Company Conditions," "Rates and Regulation," "Construction and Financing Programs" and Note B to Notes to Consolidated Financial Statements.

The Company's principal construction program for the past ten years has been related to its 15.8% interest in the Palo Verde Station. The Company anticipates that this construction program will be substantially completed during 1987, and the financing for remaining construction expenditures has been substantially completed. See Note I to Notes to Consolidated Financial Statements and "Construction and Financing Programs". Based upon present planning analyses, the Company does not expect to require additional external financing until 1989.

The Company estimates that its cash requirements during 1987 and 1988 will be met through internally generated funds and through the use of a portion of the Unit 2 sale leaseback proceeds, including earnings thereon.

The Company's longer term liquidity will therefore primarily be dependent upon obtaining adequate cash rate relief to recover its costs of providing service, including debt service, and a return on investment as well as the need to finance the effects, if any, of any rate moderation plans into which the Company may enter.

Results of Operations

The Company's results of operations (net income applicable to common stock) for each of the years 1986, 1985 and 1984 have been significantly affected by the capitalization of 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. AFUDC (net of deferred Federal income taxes on the borrowed portion of AFUDC) amounted to 86%, 81% and 83% of net income applicable to common stock during the years ended December 31, 1986, 1985 and 1984, respectively. With the

	1986 over 1985	1985 over 1984
Fuel and Purchased and Interchanged Power Expense:		
Fuel:		
Volume and average cost of fuel	$ (7,579)	$(33,684)
Other	—	342
	(7,579)	(33,342)
Purchased and interchanged power:		
Volume	(12,748)	24,167
Cost	(10,687)	12,007
	(23,435)	36,174
Total	$(31,014)	$ 2,832

The decrease in fuel expense in 1986 compared to 1985 was due to a decrease in the average cost of natural gas offset by a decrease in fuel refunds and an increase in volume of fuel consumed. 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.

Purchased and interchanged power decreased in 1986 compared to 1985 due to decreased purchases from other utilities resulting from increased availability of Palo Verde power partially offset by the major portion of Palo Verde power being accounted for as purchased power expense. For 1985 over 1984, 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.

Other Operations Expense:

Other operations expense increased in 1986 over 1985 due to expenses in 1986 associated with Palo Verde Unit 1, Unit 2 and Common Plant with no comparable expenses in 1985, increased injuries and damages expense and increased provision for uncollectible accounts. An adjustment reversing employee benefits cost expensed in prior periods partially offset the increase. Other operations expense increased in 1985 over 1984 due to increased wheeling costs associated with the transmission of electricity by other utilities and increased rate case expense. The increase was partially offset by certain accumulated preliminary survey and investigation charges in 1984 with no comparable expense in 1985.

Maintenance Expense:

Maintenance expense increased in 1986 over 1985 due to expenses in 1986 associated with Palo Verde Unit 1, Unit 2 and Common Plant with no comparable expense in 1985. Maintenance expense increased in 1985 over 1984 due to the expensing in 1985 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 1985 further reduced maintenance expense in 1984 as compared to 1985.

	1986 over 1985	1985 over 1984
Depreciation and Amortization Expense:		
Palo Verde	$4,413	$ —
Other	18	2,310
Total	$4,431	$2,310

Depreciation increased from 1986 over 1985 due to depreciating a portion of Palo Verde Unit 1 and Common Plant beginning March 1986 and a portion of Palo Verde Unit 2 beginning October 1986.

substantial completion of the Palo Verde Station as of December 31, 1986, total AFUDC is projected to decrease to approximately $36 million and $11 million in 1987 and 1988, respectively, compared to $87.8 million, $99.0 million and $99.4 million in 1986, 1985 and 1984, respectively.

As a result of the projected decrease in AFUDC, management believes that a principal factor which will affect future results of operations will be obtaining adequate rate relief in its Texas jurisdiction beginning in 1988. Because management believes that phased-in increases in rates may be the most likely form of rate relief to occur in Texas in the near future, adequate rate relief must be comprised of both an adequate level of cash rate relief and a phase-in plan which provides for the deferral and subsequent recovery of costs and a return on investment not currently recovered in cash rate relief.

Management believes that the Company is entitled to and will obtain adequate and timely rate relief. However, neither the adequacy nor the timing of rate relief can be predicted with certainty. Without such rate relief and a sufficient investment return on Unit 2 sale and leaseback proceeds, the Company's future results of operations and/or cash flow from operations would be adversely affected, and the Company's ability to obtain at satisfactory costs the additional external financing that would be required and/or continue to pay dividends on common stock at current levels could be adversely affected.

The primary reasons for increases (decreases) in results of operations for the year ended December 31, 1986 over the year ended December 31, 1985 and the year ended December 31, 1985 over the year ended December 31, 1984, are as follows (in thousands):

	1986 over 1985	1985 over 1984
Operating Revenues:		
Base:		
Rates and/or change in sales mix	$ 16,613	$(3,872)
Volume	10,374	11,951
Provision for refund (see Note L to Notes to Consolidated Financial Statements)	(13,315)	—
	13,672	8,079
Fuel:		
Recovery of fuel and purchased and interchanged power cost and other	(38,720)	4,468
Refunds	3,741	(3,107)
	(34,979)	1,361
Other operating revenues	(175)	1,136
Total	$(21,482)	$10,576

Base revenues increased for 1986 over 1985 due to an increase in base rates for FERC and New Mexico jurisdictions, a change in sales mix and increased KWH sales (volume). 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.

Fuel revenues decreased for 1986 over 1985 due to a decrease in the average cost of fuel and purchased and interchanged power recovered partially offset by decreased fuel refunds. 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.

Other operating revenues decreased for 1986 over 1985 due to decreased wheeling revenues. For 1985 over 1984, other operating revenues increased due to increased wheeling revenues.

The primary reason for the increase in depreciation for 1985 over 1984 was the additional depreciation on two transmission lines placed in-service in late 1984.

Estimated Effects of the Tax Reform Act of 1986:

The major changes in the Tax Reform Act of 1986 affecting the Company are lower tax rates, repeal of the investment tax credit, lower depreciation rates, changes in tax accounting methods accelerating the recognition of income and deferring or eliminating certain deductions, and imposing the alternative minimum tax on some of the Company's book income. The timing of the Company's major projects was such that there should be little adverse effect from the repeal of the investment tax credit. The Company anticipates that these Tax Reform Act changes will increase cash outflow but will have little impact on book earnings.

	1986 over 1985	1985 over 1984
AFUDC:		
Cumulative construction balance	$(37,253)	$ 7,747
Deferral of Palo Verde costs	23,995	—
Change due to CWIP included in rate base	2,072	(8,071)
Total	$(11,186)	$ (324)

AFUDC decreased in 1986 over 1985 due to a decreased cumulative construction balance resulting from the sale of Palo Verde Unit 2 in 1986 and the placing in service of FERC and New Mexico jurisdictional portions of Palo Verde Unit 1 and Common Plant. The decrease was partially offset by AFUDC accrued on Palo Verde deferred costs and decreased CWIP included in rate base. AFUDC decreased in 1985 over 1984 due to increased CWIP included in rate base offset in part by increased cumulative construction expenditures principally associated with the Palo Verde Station.

Interest and Net Investment Income:

Interest and net investment income in 1986 was below 1985 due to an unrealized loss on the value of certain marketable securities held by FL&R. The decrease was partially offset by the interest income earned on the portion of the proceeds from the sale and leaseback of Palo Verde Unit 2 being invested in temporary cash investments. Interest and net investment income increased in 1985 over 1984 due to interest earned on the proceeds of various debt issuances invested in temporary cash investments. Additionally, during 1985 certain investments of FL&R were sold at a gain (See Note E to Notes to Consolidated Financial Statements).

Other Income, Net:

Other income, net, decreased in 1986 below 1985 due to losses associated with FL&R's hotel operations and depreciation on property held for future use partially offset by a gain on the sale of certain rental properties of FL&R. Other income, net, decreased in 1985 below 1984 due to losses associated with FL&R's rental operations.

Interest on Long-Term and Financing and Capital Lease Obligations:

Interest on long-term and financing and capital lease obligations increased in 1986 over 1985 due to issuance of a floating rate note, pollution control bonds in 1985 and nuclear fuel lease obligations. This increase was partially offset by the early redemption of a floating rate note. The increase in long-term interest in 1985 over 1984 is due to issuance of additional first mortgage bonds in 1984, pollution control bonds, floating rate notes and nuclear fuel lease obligations.

Other Interest Expense:

Other interest expense increased in 1986 over 1985 due to an adjustment in 1985 reversing previously accrued incremental interest on short-term pollution control bonds. 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 and as a result of certain short-term obligations being refunded into long-term obligations. Additionally, incremental interest accrued 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.

	1986 over 1985	1985 over 1984
Other Interest Capitalized:		
Cumulative nuclear fuel lease balance	$(2,259)	$(1,740)
FL&R cumulative construction balance	(1,427)	(1,028)
Total	$(3,686)	$(2,768)

For 1986 over 1985 and 1985 over 1984, other interest capitalized increased due to increased cumulative nuclear fuel lease balance and increased FL&R's cumulative construction balance.

Effects of Inflation

In contrast to the analysis of increases in base revenues in the table at the beginning of "Results of Operations," it is sometimes difficult, in the case of operation and maintenance expenses, to distinguish between effects of volume increases and rises in unit costs (which, for purposes of this discussion, are all attributed to inflationary pressures).

Price changes, such as those on costs of generating fuel, are passed through to FERC customers pursuant to fuel cost adjustment provisions. Fuel price changes in the Company's Texas and New Mexico jurisdictions require fuel reconciliation hearings for the over or under recovery of fuel costs. There are a number of other major expense items such as maintenance costs, payroll costs and other operating costs that are beyond the scope of the fuel reconciliation hearings in the Texas and New Mexico jurisdictions and the fuel cost adjustment provisions for the FERC customers. Inflationary pressures on these items have given rise to earnings attrition between general rate increases. See "Rates and Regulation" in Item 1.

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, 1986 and 1985, 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, 1986. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above present fairly the consolidated financial position of El Paso Electric Company and Subsidiary as of December 31, 1986 and 1985, 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, 1986, in conformity with generally accepted accounting principles applied on a consistent basis.

PEAT, MARWICK, MITCHELL & CO.

El Paso, Texas
March 14, 1987

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

ASSETS

	December 31, 1986	December 31, 1985
	(In thousands)	
Utility plant:		
Electric plant in service	$1,098,372	$1,090,050
Less accumulated depreciation and amortization	149,728	129,667
Net plant in service	948,644	960,383
Construction work in progress	370,412	669,719
Nuclear fuel:		
Under capital leases net of amortization of $17,022,000 and $1,962,000, respectively	40,937	51,998
In process	26,500	9,453
Held for future use, net of accumulated depreciation of $12,713,000 and $11,928,000, respectively	1,366	2,151
Net utility plant	1,387,859	1,693,704
Nonutility property, at cost net of accumulated depreciation of $2,273,000 and $951,000, respectively	79,693	65,733
Investments (including restricted cash investments of $30,000,000)	81,155	58,528
Current assets:		
Cash and temporary investments	340,705	30,229
Other short-term investments	172,969	—
Accounts receivable, principally trade (less allowance for doubtful accounts of $2,462,000 and $863,000, respectively)	32,505	36,840
Federal income taxes refundable	5,028	5,073
Inventories and prepayments	23,400	18,254
Other	10,798	2,679
Total current assets	585,405	93,075
Deferred charges and other assets:		
Palo Verde deferred costs	45,678	—
Other	14,628	8,020
Total deferred charges and other assets	60,306	8,020
Total assets	$2,194,418	$1,919,060

See accompanying notes to consolidated financial statements.

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Item 8. Financial Statements and Supplementary Data

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

CAPITALIZATION AND LIABILITIES

	December 31, 1986	December 31, 1985
	(In thousands)	
Capitalization:		
Common stock, no par value, 40,000,000 shares authorized. Issued and outstanding 35,510,138 and 34,743,917 shares, respectively	$ 338,800	$ 326,033
Additional paid-in capital	475	475
Retained earnings	264,016	236,042
Common stock equity	603,291	562,550
Preferred stock, cumulative, no par value, 2,000,000 shares authorized:		
Redemption required, issued and outstanding 1,157,100 and 1,306,500 shares, respectively	115,710	130,650
Redemption not required, issued and outstanding 190,000 shares	18,873	18,873
Long-term obligations	707,278	794,713
Financing and capital lease obligations	124,643	45,865
Total capitalization	1,569,795	1,552,651
Current liabilities:		
Current maturities of long-term and financing and capital lease obligations	30,963	21,813
Bonds to be redeemed in 1987	100,000	—
Notes payable and commercial paper	10,806	38,048
Fuel purchase commitment	9,599	9,572
Accounts payable, principally trade	7,441	14,097
Taxes accrued	56,917	13,942
Interest accrued	23,412	16,825
Net overcollection of fuel revenues	15,843	4,985
Other	12,280	18,621
Total current liabilities	267,261	137,903
Deferred credits and other liabilities:		
Accumulated deferred income taxes	72,755	174,068
Accumulated deferred investment tax credit	122,185	50,771
Deferred gain on sale and leaseback of Palo Verde Unit 2	145,903	—
Accumulated provision for rate refunds	13,315	—
Other	3,204	3,667
Total deferred credits and other liabilities	357,362	228,506
Commitments and contingencies		
Total capitalization and liabilities	$2,194,418	$1,919,060

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

For the years ended December 31, 1986, 1985 and 1984

	1986	1985	1984
		(In thousands)	
Operating revenues	$ 318,109	$339,591	$329,015
Operating expenses:			
Operations:			
Fuel	44,285	51,864	85,206
Purchased and interchanged power	56,068	79,503	43,329
	100,353	131,367	128,535
Other	49,973	43,521	41,791
	150,326	174,888	170,326
Maintenance	11,700	10,205	8,234
Depreciation and amortization	19,186	14,755	12,445
Taxes:			
Federal income, current	57,379	1,503	10,818
Federal income, deferred	(100,304)	38,449	28,279
Charge (benefit) equivalent to investment tax credit, net of amortization	72,692	(716)	2,606
Other	19,755	17,211	17,364
	230,734	256,295	250,072
Operating income	87,375	83,296	78,943
Other income (deductions):			
Allowance for equity funds used during construction and deferred costs	49,595	57,349	54,663
Interest and net investment income	10,691	13,566	7,249
Other, net	(5,755)	(2,852)	(309)
Federal income taxes applicable to other income	(1,843)	(2,510)	(1,355)
	52,688	65,553	60,248
Income before interest charges	140,063	148,849	139,191
Interest charges (credits):			
Interest on long-term and financing and capital lease obligations	86,933	80,283	68,300
Other interest	4,189	1,914	9,266
Interest capitalized	(8,414)	(4,728)	(1,960)
Allowance for borrowed funds used during construction and deferred costs	(38,259)	(41,691)	(44,701)
	44,449	35,778	30,905
Net income	95,614	113,071	108,286
Preferred stock dividend requirements	14,185	14,754	13,315
Net income applicable to common stock	$ 81,429	$ 98,317	$ 94,971
Net income per share of common stock, (based on weighted average number of shares outstanding during the period)	$ 2.32	$ 2.88	$ 2.88
Dividends declared per share of common stock	$ 1.52	$ 1.49	$ 1.43
Weighted average number of common shares outstanding	35,106,903	34,161,430	33,014,649

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

For the years ended December 31, 1986, 1985 and 1984

	1986	1985	1984
		(In thousands)	
Retained earnings at beginning of year	$236,042	$188,804	$141,244
Add:			
Net income	95,614	113,071	108,286
	331,656	301,875	249,530
Deduct:			
Cash dividends:			
Preferred stock	14,185	14,754	13,315
Common stock	53,327	50,867	47,183
Capital stock expense	128	212	228
	67,640	65,833	60,726
Retained earnings at end of year	$264,016	$236,042	$188,804

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, 1986, 1985 and 1984

	1986	1985	1984
		(In thousands)	
Funds provided from operations:			
Net income	$ 95,614	$113,071	$108,286
Principal items not requiring current funds:			
Depreciation and amortization	19,186	14,755	12,445
Deferred income taxes, net	39,962	43,306	37,996
Investment tax credit, net	9,079	(3,764)	5,533
Allowance for equity funds used during construction and deferred costs	(49,595)	(57,349)	(54,663)
Unrealized loss on valuation of marketable securities	5,347	—	—
Other	4,305	2,702	1,305
Funds provided from operations before dividends	123,898	112,721	110,902
Less dividends	67,512	65,621	60,498
Funds provided from operations after dividends	56,386	47,100	50,404
Funds provided from (used for) financing:			
Sales of securities:			
Common stock	12,767	15,370	14,013
Preferred stock	—	—	50,000
First mortgage bonds	—	—	126,500
Pollution control obligations, net of amounts on deposit with trustee and interest earned	(1,277)	64,025	76,768
Secured promissory notes	97,104	72,125	16,829
Unsecured promissory notes	—	45,000	2,425
Capital lease obligations	5,174	55,160	1,221
Financing obligation (Palo Verde Unit 2)	87,427	—	—
Transfer of long-term obligations to short-term obligations	(119,322)	(21,814)	(19,813)
Redemption of long-term obligations	(77,887)	(40,219)	(41,040)
Redemption of preferred stock	(14,940)	(6,750)	(1,000)
Increase in additional paid-in capital	—	475	—
Net increase (decrease) in short-term obligations*	81,908	(46,882)	(38,046)
Net funds provided from financing	70,954	136,490	187,857
Other funds provided (used):			
Sale and leaseback of Palo Verde Unit 2, net of related income taxes	527,362	—	—
Investments	(37,276)	5,321	(24,019)
Palo Verde deferred costs	(17,679)	—	—
Net (increase) decrease in working capital other than short-term obligations, principally cash and temporary investments	(444,880)	79,340	(48,257)
Exchange of property	—	1,112	8,545
Net change in deferred accounts	(7,295)	(441)	(1,120)
Sale of nonutility property	5,516	—	—
Provision for revenue refund	13,315	—	—
Other, net	228	197	733
Net other funds provided (used)	39,291	85,529	(64,118)
Expenditures for utility plant and other plant	166,631	269,119	174,143
Allowance for equity funds used during construction **	36,021	57,349	54,663
Funds invested in utility plant and other plant	$202,652	$326,468	$228,806

* Short-term obligations are represented by the current portion of long-term and financing and capital lease obligations, bonds to be redeemed in 1987, pollution control bonds, notes payable to banks, other notes payable and commercial paper.

** Excludes the equity portion of AFUDC in the amount of $13,574,000 related to equity funds used for Palo Verde deferred costs.

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

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 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 1986 the Financial Accounting Standards Board (FASB) issued its SFAS No. 90, "Regulated Enterprises — Accounting for Abandonments and Disallowances of Plant Costs, an amendment of FASB Statement No. 71". The Statement specifies accounting for plant abandonments and disallowances of costs of recently completed plants and provides guidance for the capitalization of AFUDC. With respect to disallowances of costs of recently completed plants, the Statement specifies that when it becomes probable that part of the cost of such plant will be disallowed for rate-making purposes and a reasonable estimate of the amount of the disallowance can be made, the estimated amount of the probable disallowance shall be deducted from the reported cost of the plant and recognized as a loss. See Note B to Notes to Consolidated Financial Statements.

The FASB is currently deliberating the appropriate accounting for phase-in plans as well as accounting for regulated enterprises that no longer qualify for accounting treatment under SFAS No. 71. Because the FASB is currently considering these topics, management is unable to predict whether or to what extent new accounting standards, if any, might have any effect upon the Company.

Principles of Consolidation

The consolidated financial statements include the Company and Subsidiary (sometimes referred to herein as "FL&R"). 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. For AFUDC accrual on Palo Verde deferred costs, see Note C to Notes to Consolidated Financial Statements.

The amount of AFUDC is determined by applying an accrual rate to the balance of certain CWIP and deferred costs. 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.

The Company used a weighted average accrual rate of 11.5%, 12.2% and 13.1% for AFUDC in 1986, 1985 and 1984, 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.

Investments

Investments are stated at original cost (less valuation allowance of $5,347,000 at December 31, 1986 provided during 1986) 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 and New Mexico retail customers are presently being billed fixed fuel factors approved by the Texas Commission and New Mexico stipulation. The Texas fuel factor will remain in effect until the earlier of the Company's next general rate case or Commission ordered fuel reconciliation. In accordance with the Texas Commission and New Mexico stipulation, the utility's fixed fuel factor is subject 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 jurisdictional customers contain appropriate fuel and purchased power cost adjustment provisions designed to recover the Company's fuel and purchased power costs.

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

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.

With respect to investment tax credit generated by the Company, such investment tax credit utilized is deferred and amortized to income, once such related properties are considered "operational" by the Company's regulatory authorities, over the estimated average remaining useful lives of the Company's fixed assets directly or indirectly involved in the generation and transmission of electricity.

With respect to investment tax credit generated by the Subsidiary, such 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 1985 and 1984 have been reclassified to conform with the 1986 presentation.

B. Regulatory Matters

Texas

The Company will require adequate rate relief in its Texas jurisdiction beginning in 1988. Because management believes that phased-in increases in rates may be the most likely form of rate relief to occur in Texas in the near future, adequate rate relief must be comprised of both an adequate level of cash rate relief and a phase-in plan which provides for the deferral and subsequent recovery of costs and a return on investment not currently recovered in cash rate relief. The absence of either element of adequate rate relief in Texas would have an adverse effect upon future results of operations and/or cash flow from operations. Additionally, without adequate rate relief, the Company's ability to obtain external financing at satisfactory costs and/or continue to pay dividends on its common stock at current levels could be adversely affected. Management believes that the Company is entitled to and will obtain adequate rate relief. However, neither the adequacy nor the timing of rate relief can be predicted with certainty.

The Company intends to file with the Texas Commission in the Spring of 1987 for an increase in its annual Texas retail rates. The filing (1987 Rate Case) will be premised primarily on full inclusion in the Company's rate base of the capital costs of Palo Verde Station Unit 1, Palo Verde Common Plant and Palo Verde deferred costs and inclusion in cost of service of the lease payments on Unit 2 to the extent of the book value of plant sold and leased back, as well as all taxes related thereto. For planning purposes, the Company is assuming that the requested rate increase will become effective by November 1, 1987, on a phased-in basis.

The 1987 Rate Case will be the first time that the Texas Commission will consider the Company's requested inclusion in rate base as "plant-in-service" of the Palo Verde costs. The Company believes it is likely that the Texas Commission will examine the prudence of construction costs and lease expense related to Palo Verde Station, as well as the Palo Verde deferred costs (see Notes C and I to Notes to Consolidated Financial Statements) and the possible existence of excess generating capacity. Although there can be no assurance as to what action the Texas Commission may take with respect to determination of the prudence of the Palo Verde construction costs or the possible existence of excess generating capacity, management believes that Palo Verde has been constructed in a prudent manner, that no material excess generating capacity presently exists and that the overall construction costs incurred at Palo Verde qualify for full inclusion in the Company's rate base. As part of its 1987 rate case filing, the Company has compiled evidence, including expert testimony from independent consultants, relating to the prudence of the planning, management and construction of Palo Verde. In the opinion of counsel to the Company, based upon the evidence compiled and existing law, facts and circumstances, (i) the Company is entitled to rate relief to recover its costs of providing service plus a return on investment, and should receive such rate relief from the Texas Commission, and (ii) should the Texas Commission disallow recovery of any material portion of the costs incurred at Palo Verde based upon a finding that such costs were imprudently incurred, it is probable that rates designed to recover the Company's investment in Palo Verde and a return thereon would be obtainable through court action. Management would contest through such court action any order involving such a disallowance.

Notwithstanding the fact that the Company's present plans are to file with the Texas Commission for the rate relief described above, the Company has for some time pursued, and intends to continue to pursue, rate moderation settlements with its Texas regulators, including both the Texas Commission and the local municipalities in the Company's Texas service areas.

For information regarding the recently issued Statement of Financial Accounting Standards No. 90, "Regulated Enterprises — Accounting for Abandonments and Disallowances of Plant Costs" see Note A to Notes to Consolidated Financial Statements.

New Mexico

On March 5, 1987, the Company entered into a stipulation with certain New Mexico jurisdictional parties, including the staff of the New Mexico Commission and various New Mexico customer groups, which, subject to approval by the New Mexico Commission, provides for a settlement regarding rate treatment of the Company's investment in the Palo Verde Station. The stipulation was filed with the New Mexico Commission on March 9, 1987 and hearings are expected to commence in April 1987.

The stipulation establishes a methodology for moderating the rates of the Company in the New Mexico jurisdiction and resolves any possible issues relating to the prudence of the planning, management and construction of Palo Verde, insofar as related to the Company, and settles any possible issue of excess generating capacity through 1993. Management, based upon present planning analyses, does not expect to have excess generating capacity.

The stipulation provides that neither the capital costs of Palo Verde Unit 3, one-third of Common Plant and a proportionate share of certain Palo Verde transmission facilities (approximately $76.3 million) nor any Unit 3 operating expenses will at any time be included in the Company's rate base or receive any cost of service treatment insofar as the New Mexico jurisdiction is concerned. The costs related to the New Mexico portion of Unit 3 will need to be recovered through sales of power to wholesale customers. Although no such customers currently exist, the Company believes, based upon current market conditions and forecasts of power demand, that it can recover its costs once Unit 3 is placed in commercial operation.

Additionally, the stipulation provides for continued full inclusion in rate base in New Mexico of the remainder of the Company's investment in Palo Verde, as well as recovery of Unit 2 lease payments to the extent of the book value of the plant sold and leased back, plus all related taxes. The stipulation establishes a phase-in plan which provides for rate increases over a three year period and deferral of any unrecovered costs. Rates are required to remain constant after the third year of the plan until the earlier of full recoupment of such deferrals or December 31, 1994. The stipulation provides that any portion of such cost of service deferrals not recouped prior to December 31, 1994 will not be recovered through rates in New Mexico. Based upon present planning forecasts, the Company expects to recoup in full such cost of service deferrals prior to such date. For a discussion regarding the status of accounting standards related to phase-in plans, see Note A to Notes to Consolidated Financial Statements.

Reference is made to Part I, Item 1 — "Rates and Regulation — Rate Matters — FERC" for a discussion of pending settlements related to the Company's rates for wholesale power sales.

C. Palo Verde Nuclear Generating Station

The Company's major construction project 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, which is located near Phoenix, Arizona. Through December 31, 1986, the Company had expended $1.36 billion (including $388 million of AFUDC net of deferred taxes) for its investment in the Palo Verde Station. In separate transactions in August and December 1986, the Company sold and leased back all of its 15.8% interest in Unit 2 at Palo Verde and one-third of its 15.8% interest in certain Palo Verde Common Plant. See Note I to Notes to Consolidated Financial Statements and Part I Item 1 — "Construction and Financing Programs — Construction Program — Palo Verde Station."

At December 31, 1986, the Company's remaining ownership interest in Palo Verde aggregated net of $953 million (including $239 million of AFUDC net of deferred taxes), and estimated remaining construction expenditures related thereto aggregate $54.7 million (including $19.9 million of AFUDC deferred taxes). With the substantial completion of Palo Verde Station as of December 31, 1986, total AFUDC is projected to decrease to approximately $36 million and $11 million, in 1987 and 1988, respectively, compared to $87.8, $99.0 and $99.4 million in 1986, 1985 and 1984, respectively. AFUDC (net of deferred Federal income taxes on the borrowed portion of AFUDC) amounted to 86%, 81% and 83% of net income applicable to common stock during the years ended December 31, 1986, 1985 and 1984, respectively.

Unit 1 was placed in commercial operation by the Company in December 1985, but the Texas Commission subsequently established February 24, 1986 as the commercial operation date. In December 1986, the Company filed an application to have the Texas Commission set September 22, 1986 as the commercial operation date for Palo Verde Unit 2. Unit 3 is scheduled to commence commercial operation before year end 1987.

A summary of the Company's investment in Palo Verde Station and other jointly owned utility plant, excluding nuclear fuel, is as follows:

	Electric Plant in Service	Accumulated Depreciation	Construction Work in Progress
December 31, 1986:			
Palo Verde Station	$626,492,000	$ (4,413,000)	$332,917,000
Other	110,232,000	(15,064,000)	13,848,000
December 31, 1985:			
Palo Verde Station	631,651,000	—	648,119,000
Other	109,646,000	(10,521,000)	8,617,000

Included in the table above at December 31, 1986 is $76,343,000 of costs related to Unit 3 and common facilities which, pursuant to the New Mexico stipulation (see Note B to Notes to Consolidated Financial Statements), will not be subject to regulation in New Mexico. Substantially all of such amount is included under the caption Construction Work in Progress.

At December 31, 1986 the Company, pursuant to the most recent rate order issued by the Texas Commission — See Part I, Item 1 — "Rates and Regulation — Rate Matters — Texas" — has deferred costs in the amount of $31.3 million attributable to Unit 1 (since February 24, 1986) and Unit 2 (since September 22, 1986). The detail of such amount, which is included in Palo Verde deferred costs in the accompanying consolidated balance sheet at December 31, 1986 is as follows:

Operating expenses	$ 7,258,000
AFUDC	23,995,000
	$31,253,000

Additionally, pursuant to the Company's most recent rate orders in Texas and New Mexico, the Company has not recorded depreciation for the Texas jurisdictional portion of Units 1, 2 and Common Plant or the New Mexico portion of Unit 2 and two-thirds of Common Plant. If depreciation had been recorded on all of the Texas and New Mexico portions, additional depreciation expense of $9,157,000 would have been provided during 1986.

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 including the portion sold and leased back. 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 $97 million (stated in 1986 dollars) for decommissioning of Palo Verde. 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 nuclear fuel costs associated with Palo Verde through payments to the operating agent of Palo Verde at amounts prescribed by the Department of Energy. The Company believes that such costs will be recoverable through futures rates.

D. Depreciation and Amortization of Utility Plant

Total provision for utility plant depreciation was $20,576,000 in 1986, $14,797,000 in 1985 and $12,276,000 in 1984. The average annual depreciation rate used by the Company for utility plant other than the Palo Verde Station was 3.43%, 3.28% and 3.28% during 1986, 1985 and 1984, respectively. The average annual depreciation rate for the portions of the Palo Verde Station for which the Company is providing depreciation (see Note C to Notes to Consolidated Financial Statements) was 2.50% in 1986.

The Company is amortizing nuclear fuel under the units of heat production method. During 1986 and 1985, $15,060,000 and $1,962,000, respectively, was amortized.

E. Investments

The Company's Other Short-Term Investments include marketable securities at December 31, 1986 with an aggregate cost of $81,969,000 and an aggregate quoted market value of $80,654,000. In addition, the Company has other short-term investments in an income fund and annuities for which there are no quoted market values.

Investments in the amount of $81,155,000 at December 31, 1986 include the Company's investment in participation agreements and an annuity for which there are no quoted market values and a $30,000,000 restricted certificate of deposit. See Note I to Notes to Consolidated Financial Statements. Also included in investments at December 31, 1986 are FL&R's investments in preferred stocks in the amount of $16,478,000. At December 31, 1985 the aggregate cost of FL&R's investments in preferred stocks was $28,901,000. FL&R also had certain other investments including securities which had a cost of $9,500,000 at December 31, 1986 and 1985 for which there are no quoted market values.

F. 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 1986, 1985 and 1984, common stock totaling 10,045, 11,150 and 9,253 shares, respectively, were purchased pursuant to the plan for $143,000, $140,000 and $87,000, respectively. The corresponding fair market values as of the option exercise dates were $158,000, $171,000 and $95,000, respectively. At December 31, 1986, shares reserved for issuance under the plan were 179,539.

Dividend Reinvestment and Stock Purchase Plan

The Company had a dividend reinvestment and stock purchase plan under which holders of record of common stock purchased 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 1986, 1985 and 1984, shareholders purchased from the Company 631,306, 921,463 and 1,110,840 shares, respectively, for $10,649,000, $13,544,000 and $13,010,000, respectively. As of December 31, 1986 this plan was terminated.

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. No employee cash participation is permitted by the plan. In October 1986, 1985 and 1984, the Company contributed 7,113, 8,032 and 11,172 shares of common stock to the plan, with respect to the 1985, 1984 and 1983 tax years, respectively, with market values of $121,000, $111,000 and $130,000, respectively. At December 31, 1986, shares reserved for future contributions by the Company to the plan were 224,707.

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 1986, 1985 and 1984, common stock totaling 36,934, 44,354 and 66,873 shares, respectively, were purchased by customers of the Company in the amounts of $616,000, $651,000 and $786,000, respectively. At December 31, 1986, shares reserved for issuance under the plan were 610,471.

Employee Stock Compensation Plan

The Company has an Employee Stock Compensation Plan under which shares of Company common stock are issued from time to time 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 1986 and 1985, 80,823 and 61,363 shares, respectively, were issued in the amount of $1,237,000 and $924,000, respectively. At December 31, 1986, 157,814 shares were reserved for future contributions under the plan.

Leveraged Employee Stock Ownership Plan and Trust

The Company has a Leveraged Employee Stock Ownership Plan and Trust (LESOP) which has borrowed money that was used to purchase Company common stock on the open market for allocation to eligible employees. During 1986 and 1985, the LESOP purchased 415,551 and 881,500 shares, respectively, of common stock of which 162,131 shares have been allocated.

Changes in Common Stock

Changes in common stock are as follows:

	Common Stock Shares	Common Stock Amount (In thousands)
Balance December 31, 1983	32,499,417	$296,650
Sales of Common Stock:		
1984	1,198,138	14,013
1985	1,046,362	15,370
1986	766,221	12,767
Balance December 31, 1986	35,510,138	$338,800

G. Preferred Stock

Preferred Stock, Redemption Required

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

	December 31, 1986 Shares	1986 Amount (In thousands)	1985 Shares	1985 Amount (In thousands)	Optional Redemption Price Per Share at December 31, 1986
$10.75 Dividend	72,000	$ 7,200	76,000	$ 7,600	$105.250
$ 8.44 Dividend	127,600	12,760	138,000	13,800	106.330
$ 8.95 Dividend	127,500	12,750	142,500	14,250	106.710
$ 9.00 Dividend	—	—	100,000	10,000	—
$ 9.50 Dividend	80,000	8,000	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
	1,157,100	$115,710	1,306,500	$130,650	

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

1987	$ 3,750
1988	3,750
1989	8,750
1990	18,750
1991	16,750

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

	Shares	Amount (In thousands)
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
Redemption of Preferred Stock, $10.75 Dividend	(4,000)	(400)
Redemption of Preferred Stock, $8.44 Dividend	(10,400)	(1,040)
Redemption of Preferred Stock, $8.95 Dividend	(15,000)	(1,500)
Redemption of Preferred Stock, $9.00 Dividend	(100,000)	(10,000)
Redemption of Preferred Stock, $9.50 Dividend	(20,000)	(2,000)
Balance at December 31, 1986	1,157,100	$115,710

Preferred Stock, Redemption not Required

Following is a summary of preferred stock at December 31, 1986 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, 1986.

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 $9.50 preferred stock issue, are entitled to an amount per share equal to the applicable optional redemption price plus accrued dividends, upon voluntary liquidation. The $9.50 preferred stock issue is entitled to a fixed price ($105.70 per share at December 31, 1986) plus accrued dividends, upon voluntary liquidation.

H. Long-Term and Financing and Capital Lease Obligations

Outstanding long-term and financing and capital lease obligations are as follows:

	Redemption Price at December 31, 1986(1)	December 31, 1986	December 31, 1985
		(In thousands)	
Long-Term Obligations:			
First Mortgage Bonds(2):			
4¼% Series, issued 1958, due 1988	100.30%	$ 6,100	$ 6,100
4⅝% Series, issued 1962, due 1992	101.01	10,385	10,385
6¾% Series, issued 1968, due 1998	102.57	24,800	24,800
7¾% Series, issued 1971, due 2001	104.31	15,838	15,838
9% Series, issued 1974, due 2004	104.99	20,000	20,000
10½% Series, issued 1975, due 2005	107.09	15,000	15,000
8½% Series, issued 1977, due 2007	106.04	25,000	25,000
9.95% Series, issued 1979, due 2004	109.95	22,874	23,937
16.35% Series, issued 1981, due 1991(14)	—	40,000	40,000
16.20% Series, issued 1982, due 2012(14)	113.97	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 $10,683,000 and $9,958,000, respectively, on deposit with trustee(4)		52,817	53,542
Variable rate refunding bonds, due 2014, net of $4,796,000 and $4,573,000, respectively, on deposit with trustee(5)		32,304	32,527
Variable rate refunding bonds, due 2015(6)		59,235	59,235
Unsecured:			
Variable rate refunding bonds, due 2013, net of $5,518,000 and $5,189,000, respectively, on deposit with trustee(4)		30,287	30,616
Balance forward		$541,140	$543,480

	December 31, 1986	December 31, 1985
	(In thousands)	
Balance forward	$541,140	$543,480
Floating rate notes secured by Second Mortgage Bonds(2)(7):		
Due 1987	—	75,000
Due 1988	75,000	75,000
Due 1991	70,000	—
Promissory notes:		
Secured:		
Due 1987, bearing interest at 13% per annum(8)	2,736	5,623
Due 1996 ($480,000 due in 1987)(9)	59,163	37,224
Due 2004, two notes bearing interest at 5% per annum through December 1988 and 10% thereafter and one at 9.25%. Payable in installments through 2004 ($319,000 due in 1987)(8)	10,385	5,530
Unsecured(10):		
Due 1989 ($425,000 due in 1987)	1,370	1,754
Due 1990 ($301,000 due in 1987)	21,460	21,726
Due 1992	25,000	25,000
Mortgage notes payable, interest 12%, 8.8125% and 14% per annum in 1986 and 12.75%, 8.8125% and 14% per annum in 1985. Payable in installments through 2004 ($157,000 due in 1987)	8,074	8,215
Total long-term obligations	814,328	798,552
Financing and Capital Lease Obligations:		
Financing obligation, Palo Verde Unit 2 ($217,000 due in 1987)(13)	87,427	—
Turbine lease ($1,438,000 due in 1987)(11)	12,631	12,894
Nuclear fuel ($23,830,000 due in 1987)(12)	50,070	52,642
Total financing and capital lease obligations	150,128	65,536
Total long-term and financing and capital lease obligations	964,456	864,088
Amounts due within one year:		
Bonds to be redeemed in 1987(14)	(100,000)	—
Current maturities	(30,963)	(21,813)
Unamortized discount and premium	(1,572)	(1,697)
	$831,921	$840,578

(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, 1986 and 1985 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 in April 1985 and April 1990, respectively, the Company is 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 $195,897,000 are unrestricted as to the payment of cash dividends at December 31, 1986.

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 1988 and 1991.

(3) The funds on deposit with a trustee at December 31, 1986 represent a portion of the proceeds from pollution control revenue bonds and accumulated related interest income, which such funds are to be disbursed as needed to pay the cost 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 1986 the interest rate on the variable rate bonds, due 2014, was 5.5% until July 1, 1986 and 4.625% thereafter. With respect to the variable rate refunding bonds, due 2013, the interest rate during 1986 was 5.875% until November 1, 1986 and 4.25% 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 1986 the bonds bore an interest rate of 5.625% until May 20, 1986, 4.75% until June 19, 1986 and 4.5% 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% until July 31, 1986 and 5.5% 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.

(7) At the option of the Company, the interest rate on the note due 1988 (7.9375% at December 31, 1986) may be determined using the bank's prime rate, a CD or LIBOR rate. This note may be prepaid at the option of the Company without premium.

The interest rate on the note due 1991 is to be determined using the bank's prime rate, a CD or Eurodollar rate. Pursuant to an interest swap agreement, the interest rate is 9.955%.

(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. Principal and interest is payable in equal quarterly installments of $2,000,000. 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, 6.5625% at December 31, 1986.

(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. Semiannual 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 $831,000 interest accrued is reflected in long-term obligations at December 31, 1986. 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 $20,817,000 for Unit 1 and $29,253,000 for Unit 2 at December 31, 1986 (interest rate of 9.31% at December 31, 1986). Quarterly lease payments based on units of heat production with respect to Unit 1 began in the first quarter of 1986 and in the first quarter of 1987 for Unit 2.

(13) In December 1986 the Company entered into an obligation related to the sale and leaseback of Palo Verde Unit 2 (See Note I to Notes to Consolidated Financial Statements). The Company recorded the obligation in the amount of $87,427,000 at December 31, 1986 (using an assumed interest rate of 8.45% at December 31, 1986). Semiannual payments, including interest, beginning in July 1987 are $4,181,000 with the last payment being $2,091,000 in July 2013.

(14) During 1987, the Company intends to redeem the 16.35% and 16.20% series in the aggregate amount of $100,000,000.

Scheduled maturities of long-term and financing and capital lease obligations and sinking fund requirements at December 31, 1986 are as follows (in thousands):

1987	$132,143
1988	104,657
1989	110,942
1990	34,245
1991	82,340

I. Sale and Leaseback of Palo Verde Unit 2

In August and December of 1986, the Company consummated eight separate sale and leaseback transactions (one of which has been accounted for as a financing transaction) representing its entire 15.8% undivided interest in Palo Verde Unit 2 and one-third of its undivided interest in certain Common Plant at Palo Verde. The eight transactions are collectively referred to in this document as the Unit 2 sale and leaseback transactions. The total consideration received by the Company from such transactions, which was based upon appraised fair market value, was approximately $684.4 million, of which $597 million has been accounted for as operating leases (representing book value of $448.5 million), and $87.4 million which has been accounted for as a financing transaction (representing book value of $65.5 million).

The operating leases expire in October 2013 with options to renew for various terms not expected to expire later than October 2017. The Company has an option under each lease to repurchase the related undivided interest in the Unit at the end of the lease term at its then fair market value. With respect to leases accounted for as operating leases the Company is required to make semiannual lease payments of approximately $28,750,000, payable in advance beginning in 1987. The Company has deferred recognition of lease expense during 1986 to the extent anticipated to be recovered through rates.

One of the transactions was with an affiliate of a federal savings and loan association and has been accounted for as an $87.4 million financing transaction (See Note H to Notes to Consolidated Financial Statements) because of the Company's proposed $60 million purchase of floating rate exchangeable preferred stock to be issued by the federal savings and loan association. An executive officer of a subsidiary of the Company serves on the board of directors of another affiliate of the federal savings and loan association, such other affiliate having received equity placement fees of approximately $2.0 million in connection with the August and December sale and leaseback transactions discussed above.

The total proceeds from the Unit 2 sale and leaseback transactions were approximately $684,400,000 (including the financing transaction) and resulted in a gain on the sale of approximately $145,900,000. The gain on the sale is deferred and will be amortized into income over the term of the leases in conjunction with the lease payments.

Upon the occurrence of specified events of loss or deemed loss events under a lease, the occurrence of each of which events is considered by the Company to be remote, the Company is obligated to pay the related equity investor an amount in cash which, primarily because of certain tax consequences, may exceed the equity investor's unrecovered equity investment. Upon payment of such amount and assumption of the debt portion of the purchase price of the undivided interest, the undivided interest will be transferred to the Company. Approximately 20% of the aggregate purchase price of the undivided interests sold in the Unit 2 sale and leaseback transactions was provided by the equity investors, with the balance being provided through the issuance of non-recourse debt by the lessor/purchasers. At December 31, 1986, no event of loss had occurred, and no deemed loss event had been declared.

The Company has agreed to indemnify the lessors in certain circumstances against certain losses, including loss of certain tax benefits resulting from specified events. Additionally, the terms of the agreements contain various restrictive covenants including a limitation on the incurrence of debt. As of December 31, 1986, no indemnity event had occurred and the Company was in compliance with the terms of the agreements.

The Company remains responsible, under the terms of all the leases, for all operation and maintenance costs, decommissioning costs, nuclear fuel costs, and other related operating costs of the

Unit and related Common facilities. The Company is also required to maintain a cash collateralized letter of credit in the amount of $30,000,000 in connection with one of the December transactions.

Future minimum annual rental payments required under the original lease terms for sale and leaseback transactions accounted for as operating leases are as follows (in thousands):

1987	$ 53,000
1988	57,500
1989	57,500
1990	57,500
1991	57,500
Thereafter	1,238,700

J. Short-Term Obligations

At December 31, 1986, the short-term obligations of FL&R totaled approximately $10,800,000. Such obligations consisted of notes payable to banks and other notes payable. The Company and FL&R maintained informal lines of credit which totaled approximately $157,300,000 and $11,600,000, respectively, at December 31, 1986. Most of these arrangements provide for the payment of lines of credit fees of various negotiated amounts. At December 31, 1986, there were no advances outstanding under the Company's lines of credit, while FL&R had approximately $10,800,000 of advances outstanding under its lines of credit. FL&R 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, 1987, in an amount not to exceed $200,000,000 outstanding at any one time.

K. Federal Income Taxes

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

	Years Ended December 31,		
	1986	1985	1984
		(In thousands)	
Tax effect of:			
Operating income:			
Depreciation differences	$ 15,187	$ 7,365	$ 3,424
Deferred fuel revenues	(4,995)	2,779	(2,145)
Provisions for rate refunds	(6,125)	—	—
Allowance for borrowed funds used during construction	12,805	19,178	20,562
Allowance for borrowed funds deferred	4,794	—	—
Taxes capitalized	2,916	3,166	2,762
Nuclear fuel expense differences	(3,301)	2,940	4,367
Capitalized Palo Verde operation and maintenance expenses	5,967	4,370	443
Palo Verde Unit 2 Sale/Leaseback	(129,062)	—	—
Other	1,510	(1,349)	(1,134)
Other income:			
Tax leases	4,140	4,733	5,661
Other	2,068	2,903	1,911
	$ (94,096)	$46,085	$35,851

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, 1986	1985 (In thousands)	1984
Tax computed at statutory rate	$ 58,524	$ 71,216	$ 69,618
Decreases due to:			
Allowance for equity funds used during construction	(22,814)	(26,381)	(25,145)
Other	(4,100)	(3,089)	(1,415)
Total Federal income tax expense	$ 31,610	$ 41,746	$ 43,058
Effective Federal income tax rate	24.85%	26.96%	28.5%

The detail of Federal income taxes by component are as follows:

	Years Ended December 31, 1986	1985 (In thousands)	1984
Current income taxes:			
Operating	$ 57,379	$ 1,503	$10,818
Other income	(14,193)	(2,078)	(9,144)
Total	43,186	(575)	1,674
Deferred income taxes:			
Operating	(100,304)	38,449	28,279
Other income	6,208	7,636	7,572
Total	(94,096)	46,085	35,851
Charge (benefit) equivalent to investment tax credit:			
Operating	73,425	(217)	3,105
Other income	9,887	(3,044)	2,931
Total	83,312	(3,261)	6,036
Amortization of investment tax credit:			
Operating	(733)	(499)	(499)
Other income	(59)	(4)	(4)
Total	(792)	(503)	(503)
Total Federal income tax expense	$ 31,610	$41,746	$43,058

At December 31, 1986, the Company and the Subsidiary had available for Federal income tax purposes investment and rehabilitation tax credit carryforwards in the aggregate amount of approximately $6,400,000 expiring in 2001.

At December 31, 1986, the cumulative net amount of income tax timing differences on which deferred income taxes have not been provided approximated $17,000,000.

L. Commitments and Contingencies

The Company has appealed to the state district court the Texas Commission's rate case order in the Company's 1985 rate case to decrease non-fuel base rates by approximately $14,300,000. The order was stayed pending appeal. During 1986, the Company credited a reserve in the amount of $10,000,000 for amounts collected which are subject to refund. Additionally, certain amounts collected in connection with interim rates allowed by the FERC are subject to refund. The Company credited a reserve in the amount of $3,300,000 through December 31, 1986 for refund with regard to these collections.

The estimated aggregate costs of completion and betterments related to Palo Verde Units 1, 2 and 3 to be incurred by the Company subsequent to December 31, 1986, are approximately $89,100,000, which includes AFUDC (net of related deferred tax) in the amount of $19,900,000.

Other construction commitments for the Company subsequent to December 31, 1986, total approximately $50,300,000, which includes AFUDC (net of related deferred tax) in the amount of $6,700,000.

The Company has a nuclear fuel purchase commitment with an independent trust which is not reflected in the Company's balance sheets. 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 purchasing 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 $43,000,000 at December 31, 1986). The Company intends to elect to purchase the heat as the basis for payment for future fuel loadings.

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, 1991.

The Company has filed with the New Mexico Commission for approval to purchase $60 million of floating rate, $100 par value exchangeable preferred stock to be issued by a federal savings and loan association. See Note I of Notes to Consolidated Financial Statements and Part I, Item 1 — "Rates and Regulation — Diversification Program" included elsewhere herein.

The Company and FL&R 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.

M. Pension Plan

The Company's Retirement Income Plan for Employees of El Paso Electric Company (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, 1986	January 1, 1985
	(In thousands)	
Net assets available for plan benefits	$25,663	$21,970
Actuarial present value of accumulated plan benefits:		
Vested benefits:		
Participants currently receiving payments	$ 8,470	$ 8,195
Other participants	16,283	14,949
	$24,753	$23,144
Nonvested benefits	1,238	1,063
Total actuarial present value of accumulated plan benefits	$25,991	$24,207

The pension cost in 1986, 1985 and 1984 was $2,605,000, $1,448,000 and $1,544,000, respectively, which includes amortization of past service cost over a thirty-year period beginning in 1972.

N. 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)					
1986						
1st quarter	$77,557	$58,420	$19,137	$26,372	$22,744	$.65
2nd quarter	78,967	59,210	19,757	22,302	18,674	.54
3rd quarter	86,276	57,256	29,020	27,751	24,122	.68
4th quarter	75,309	55,848	19,461	19,189(1)	15,889	.45
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

(1) The decline in net income during the fourth quarter of 1986 as compared to the third quarter of 1986 was due primarily to the proceeds from the sale and leaseback of Palo Verde Unit 2 not being fully utilized to redefine the Company's capital structure and a reversal in the third quarter of previously accrued employee benefit cost.

Item 9. Changes in and Disagreements with Accountants 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 1987 Proxy Statement. Information regarding executive officers of the Company, under the caption "Executive Officers of the Registrant" in Part I, Item 1 above, is incorporated herein by reference.

Item 11. Executive Compensation

Incorporated herein by reference from the 1987 Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management

Incorporated herein by reference from the 1987 Proxy Statement.

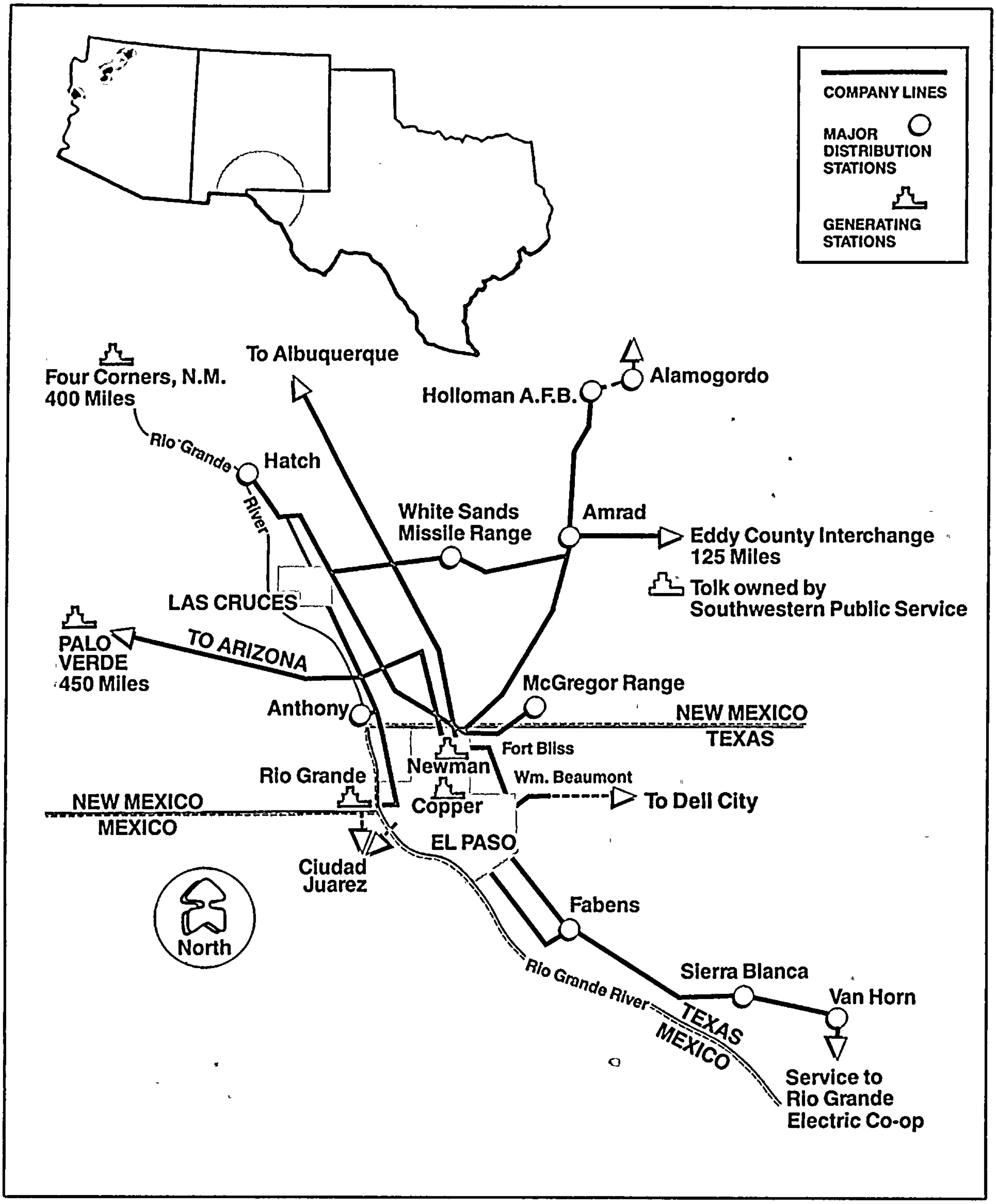
Item 13. Certain Relationships and Related Transactions

Incorporated herein by reference from the 1987 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.



COMPANY LINES
MAJOR DISTRIBUTION STATIONS
GENERATING STATIONS
Four Corners, N.M.
400 Miles
To Albuquerque
Holloman A.F.B.
Alamogordo
Rio Grande River
Hatch
White Sands Missile Range
Amrad
Eddy County Interchange
125 Miles
Tolk owned by Southwestern Public Service
LAS CRUCES
PALO VERDE
450 Miles
TO ARIZONA
McGregor Range
Anthony
NEW MEXICO
TEXAS
Fort Bliss
Newman
Wm. Beaumont
Rio Grande
To Dell City
NEW MEXICO
MEXICO
Copper
EL PASO
Ciudad Juarez
North
Fabens
Sierra Blanca
Van Horn
Rio Grande River
TEXAS
MEXICO
Service to Rio Grande Electric Co-op

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

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