

PNM

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Annual Report 1986

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About PNM

Public Service Company of New Mexico is a combined utility with diversified interests. The total population of the area served by one or more of the Company's utility services is approximately 960,000, or 65 percent of the state's population.

In addition to electric and gas services, the Company also:

- provides water utility services to the City of Santa Fe, through the Sangre de Cristo Water Company; and
- owns and operates mining and diversified capital companies.

In diversifying, we seek to improve our earnings while also strengthening the economy of our utility service areas.

Our primary service territories are in New Mexico—"The Land of Enchantment"—one of the most magnificent regions on earth. In this report, we would like to share this land in which we live, work, and grow. New Mexico is a land of vast horizons, and we look forward to our future with confidence and excitement.

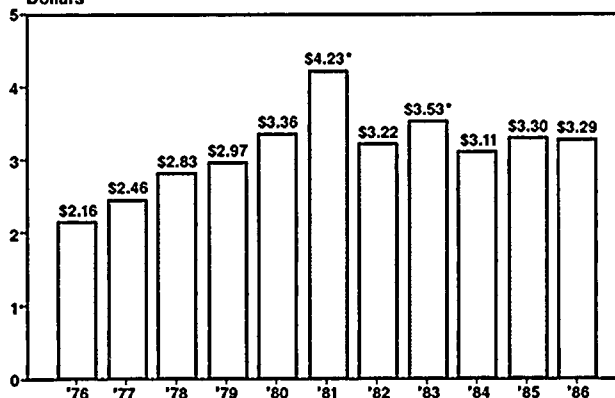
Annual meeting of shareholders

The annual meeting of stockholders of Public Service Company of New Mexico will be held at the Kimo Theatre, 423 Central Avenue, N.W., Albuquerque, New Mexico, on Tuesday, June 23, 1987, at 9:30 a.m. Stockholders are urged to attend; however, whether or not attending, proxies should be mailed to the Company. A proxy statement and form of proxy will be mailed to stockholders on or about May 11, 1987.

■ On the cover: (top to bottom) Falcon Ridge, Arizona; Meadows Resources, Inc. ■ San Juan Generating Station, New Mexico; Electric Operations. ■ Dogie Canyon Compressor Station, New Mexico; Gas Operations. ■ De-Na-Zin/Gateway Coal Mine, New Mexico; Sunbelt Mining Company, Inc.



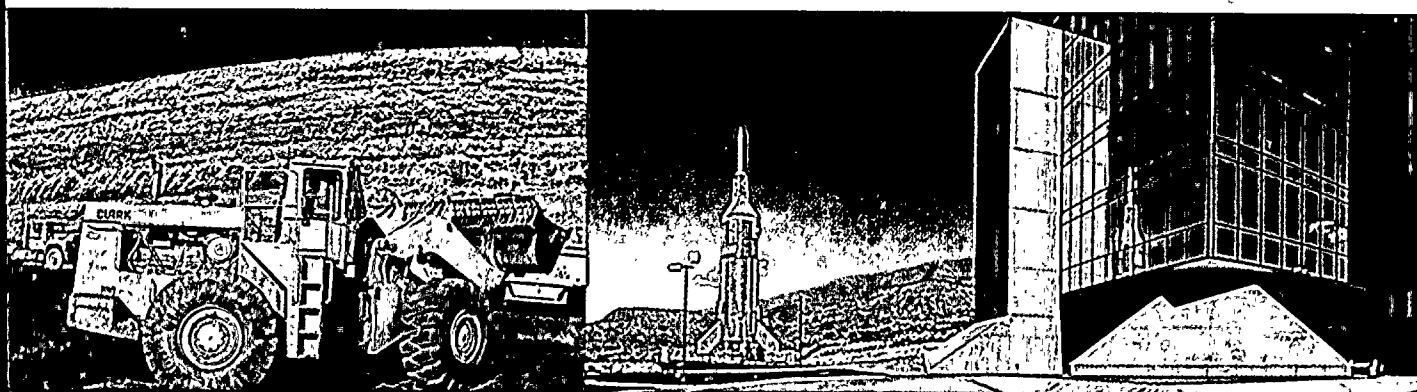
Earnings Per Share of Common Stock
Dollars



*Includes sale of retained economic interest in coal leases which contributed \$.90 and \$.73 per share, respectively in 1981 and 1983.

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Public Service Company of New Mexico and Subsidiaries

Financial Highlights	1986	1985	% Change
Operating revenues	\$ 697,995,000	\$ 689,982,000	1.2
Operating expenses	\$ 517,519,000	\$ 504,868,000	2.5
Net earnings	\$ 151,005,000	\$ 146,310,000	3.2
Return on average common equity	12.8%	13.2%	(3.0)
Earnings per common share	\$ 3.29	\$ 3.30	(0.3)
Dividends paid per common share	\$ 2.92	\$ 2.89	1.0
Book value per common share at year-end	\$ 26.51	\$ 25.73	3.0
Utility construction expenditures	\$ 200,031,000	\$ 261,931,000	(23.6)
Electric			
Total kilowatt-hour sales*	6,727,530,000	7,437,062,000	(9.5)
Gas			
Decatherm sales	52,520,000	55,161,000**	(4.8)

*Includes other contracted energy sales of 1,625,217,000 kWhr and 2,200,952,000 kWhr in 1986 and 1985, respectively.

**From the acquisition date, January 28, 1985.

To the stockholders:

In 1986 we achieved some solid financial results in a difficult environment.

Net earnings applicable to common stock were \$132.8 million, or \$3.29 per share, compared with \$122.4 million, or \$3.30 per share in 1985. Non-cash earnings related to construction and "inventoried" generating capacity contributed 43 percent of our total earnings. A series of tax benefits, which are not expected to recur at the same high level in future years, contributed \$1.03 earnings per share.

The Board of Directors maintained our quarterly dividend on common shares, but did not increase it, for the first time in 15 years.

The difficulties we faced:

A sustained slump in the mining and oil and gas industries has slowed economic growth in New Mexico.

In 1986 our uranium mining customers used only 14 percent of the electricity they used seven years ago—and only three percent of their projected peak usage. Coal mining customers used only 40 percent of projected peak.

The depression in New Mexico's oil and gas fields was felt throughout the state, even in Albuquerque—the state's major business center and our major service area.

In Albuquerque, the electronics industry—hit by international competition—has not expanded as projected.

In fact, our electric utility's largest retail customer added in the last six

years has been our own Meadows Resources' fiberboard plant in Las Vegas, New Mexico.

Result: uncommitted capacity

The result is that PNM—as do many other utilities—has more generating capacity than our customers can use. Generating plants, especially nuclear, require years to plan and build. But the present economy has disproved past forecasts.

The regional wholesale power market has been little better. Many utilities have uncommitted capacity. Wet years in the West yielded cheap hydroelectric power. Low oil and gas prices led to reactivating oil- and gas-fired power plants.

We also faced regulatory setbacks. Our most recent request for higher electric rates resulted in a \$4.5 million revenue reduction. Proposed accounting rule changes, involving national accounting standards, may adversely affect the viability of our ratemaking method called "inventory of capacity". The New Mexico Public Service Commission has scheduled a proceeding to obtain proposals for alternatives to the inventory methodology.

We had to fight a biased Palo Verde construction audit. The regulatory effort to audit our interest in Palo Verde resurfaced in a new investigation by the Public Service Commission. We continue to work toward an equitable regulatory solution regard-

ing recovery of our investment.

Regional initiatives and the business environment

- Our electric utility cut \$10 million in operations and maintenance costs.
- We have reduced the cost of our gas by one-third.
- We were the first-in-the-nation to sell and lease back an interest in a nuclear plant. In 1985 and 1986, we completed the sale and leasebacks of our interests in Palo Verde Units 1 and 2.
- Meadows Resources' investments in New Mexico businesses have started to build utility loads.

But today's challenges require even greater efforts. In earlier reports and meetings I have discussed the far-reaching changes under way in the utility industry. Two observations make these changes clearer.

First: Changes in the natural gas industry: Wellhead prices deregulated, interstate pipelines opened, contract carriage, gas companies divided into production—pipeline—distribution companies, mergers as stronger companies absorbed the weak.

At Gas Company we've experienced some of these changes. And we feel they foreshadow similar change in the electric industry.

Second: As chairman of the Edison Electric Institute (the national association of investor-owned electric utilities), I've watched our industry's transformation in a broader framework: The unwillingness of regulators



to continue to enforce major terms of the "regulatory compact" between utility suppliers and customers. The growth of energy alternatives. The impact of international competition—on utilities directly and through their customers.

Agenda for tomorrow

This rapidly changing environment calls for bold initiatives. There are no easy solutions.

And so, with your support, we continue to pursue new strategies. Our business objectives include:

- becoming one of the lowest-cost providers in our region through cost control, regulatory acceptance and innovative financing;
- becoming a holding company and thereafter restructuring our utilities;
- expanding our non-utility investments in telecommunications manufacturing, financial services, and real estate;
- a new, stronger commitment to

business development in New Mexico and the Southwest.

- With the new state administration in Santa Fe, we are pursuing a program to exchange the old regulatory risks for new competitive opportunities.

PNM will take action to resolve outstanding regulatory issues and form the holding company approved by our stockholders last May. Among other benefits, this will provide greater flexibility for our investment and mining companies.

Thereafter, the utility subsidiary would divide its utility operations into separate entities to respond to market trends—for example, an electric distribution entity and an electric generation and transmission entity. This could allow more effective competition in the new marketplace.

Each separate utility entity would take action to lower its costs. This would make our utility services more competitive and boost local business

Jerry D. Geist
Chairman and President
Public Service Company of New Mexico

development. One alternative which we are studying is the formation of a limited partnership which would conduct the electric distribution business of PNM.

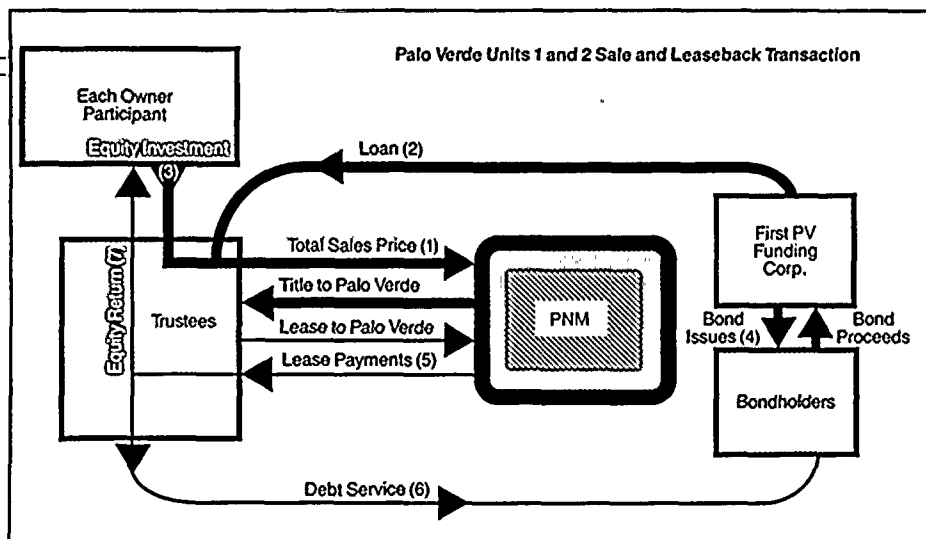
The Chinese sign for crisis is a combination of the signs for "danger" and "opportunity". We are conscious of current dangers. But we look forward with confidence and excitement to your company's future opportunities.

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Sincerely,

Jerry D. Geist
Chairman and President
March 4, 1987

Corporate office initiates strategic policy



■ In 1985 and 1986, PNM sold its interests in Palo Verde Units 1 and 2 (and certain common facilities) to several investors (box shown as Each Owner Participant). The total sales price was \$900 million (1), of which approximately \$714 million was loaned (2) to the participants by First PV Funding Corp., a corporation organized solely to provide debt financing for the participants; the participants invested \$186 million as

equity (3). First PV Funding Corp. obtained permanent financing for the loans by issuing long-term lease obligation bonds (4). Simultaneous with the sale, the Company leased back the Units for a basic term of about 29 years at a rental of approximately \$84 million per year (5). Under the leases, PNM's rental payments are used first to service the lease obligation bonds (6), with the remainder going to the participants (7).

Working with the Company's four business units, the corporate office's business and financial planners, public policy advisors, tax analysts, and corporate policy and communication advisors develop specific plans and policies for consideration by the Corporation's senior management and Board of Directors. Adopted programs are put into action by the business units themselves assisted as required by the corporate office's financial management, investor services, and government affairs staff.

The corporate office's major activities in 1986 were the nuclear facility sale/leasebacks of our interest in Palo Verde Units 1 and 2, the

■ (left) Al Robison, senior vice president and chief financial officer (at right), and Lloyd Williams, managing director of Kidder, Peabody & Co., a major PNM underwriter, during closing activities of a sale and leaseback transaction. PNM was the first corporation in the nation to sell and lease back a nuclear generating plant. The Company sold for \$900 million and leased back its entire interest in Palo Verde Units 1 and 2.



■ (above) J. B. "Bud" Mulcock, Jr., senior vice president of corporate affairs and secretary, helps make the strategic decisions for PNM. Mr. Mulcock is also responsible for the Company's stockholder services, investor relations, and other public affairs activities.

cost-cutting retirement of high-interest bonds and redemption of high dividend preferred stock, the effort to secure regulatory approval for holding company organization, and the Dineh Power Project.

Holding company plan is key to new era

Shareholders approved the holding company plan in May 1986. However, the New Mexico Public Service Commission denied our plan, claiming that the new structure would make it more difficult to review and regulate transactions between utility and nonutility operations. We appealed the Commission's decision to the New Mexico Supreme Court.

The new holding company struc-

ture, if implemented, would increase the Company's financial flexibility and more distinctly separate utility and nonutility operations.

The holding company plan is not unique. More than 20 utilities have reorganized as holding companies in the last decade.

Dineh partnership would export energy

Economic and demographic forecasts for the 1990s indicate there will be electric generating capacity shortages in the Southwest and Pacific Coast regions. The proposed Dineh Power Project would respond to that need.

Proposed as a joint venture with the Navajo Nation and several other

major corporations, Dineh would export New Mexico's abundant coal resources in the form of electricity.

The project would include a coal-fired electric generating plant on Navajo land in northwestern New Mexico. The site is near coal resources controlled by PNM's Sunbelt Mining Company and others. These resources would provide the plant's coal. The Dineh project would also include the construction of a 500 kV transmission line to carry electricity to wholesale customers.

The U.S. Congress included a provision in the new tax law which will preserve an investment tax credit until 1995 for construction of the Dineh project.

Other participants in the Dineh project include the Navajo Nation, Bechtel Power Corporation, and Combustion Engineering, Inc. The corporate office has committed to continue funding a portion of the Dineh study. Neither we nor the other participants would begin construction until agreements have been signed with utilities or other buyers to buy a significant portion of Dineh power.

Electric utility faces capacity, competition, and regulatory challenges

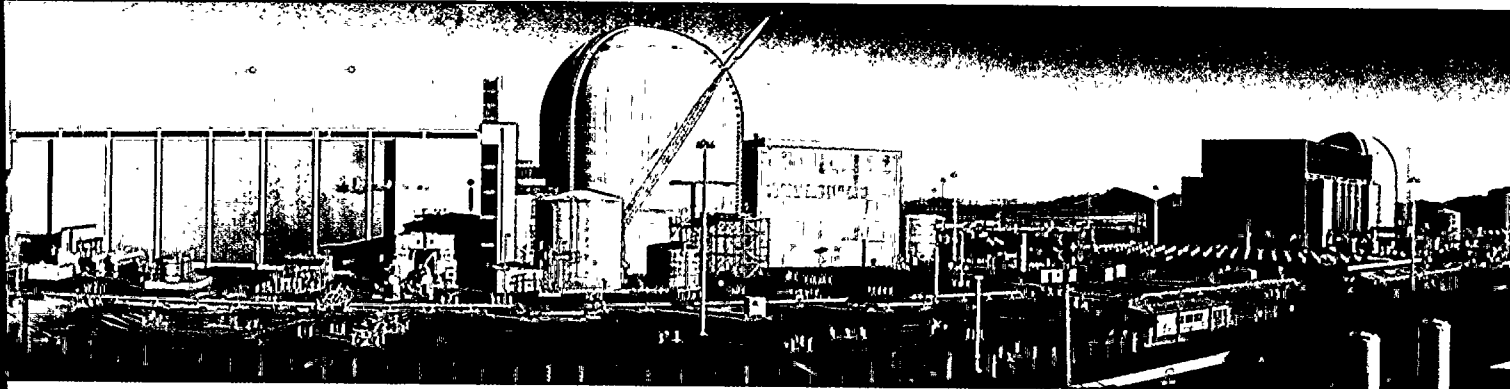


■ (above) Atop Palo Verde's Unit 3 reactor vessel, technicians inspect the unit during its pre-operational phase. Unit 3 first generated non-nuclear powered electricity November 1986 as part of an important test of the unit's turbine and generator.

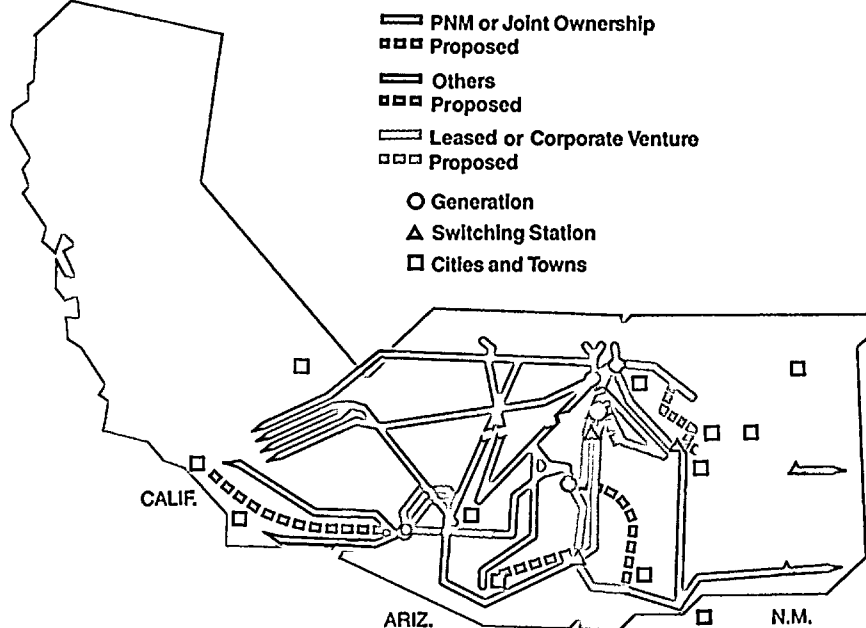
■ (below) Martha McDonald, vice president of human resources and support services, and Dwayne Pruitt, equipment operator and union steward, discuss safety issues at an Albuquerque maintenance and service center. From centers like this one, transmission and distribution lines and facilities are constructed and maintained.



■ (above) John Bundrant, president and chief operating officer of electric operations, visits the Indian Pueblo Cultural Center in support of the electric utility's Customer Success program. Business growth teams provided advice on the Center's energy usage and marketing and management functions.



**Major Southwestern
Electric System Map**
All Lines 230 kV and Higher



We began as an electric, gas, and ice utility. Today, electric sales account for 65 percent of total operating revenues.

The electric utility as an energy marketer

As output increases from Palo Verde Nuclear Generating Station, the importance of sales to other utilities also increases. With Unit 2's operation, our off-system sales to San Diego Gas & Electric Company increased from 106 MW to 236 MW.

Off-system energy sales to other utilities represented 33.5 percent of the Company's total kilowatt-hour sales.

Our sales to other utilities in 1986 decreased because of our system's relative cost and transmission access limitations. In response, we are striving to lower costs as well as develop new markets in our service areas, in the Southwest, and in adjoining regions.

Projected New Mexico retail electric sales growth of about 3 percent in

■ (above) Palo Verde Units 1 and 2 began commercial service in January and September 1986. In October, Unit 2 set a new record for United States nuclear plants, generating 987,300 megawatt-hours. Upon completion of Unit 3, the electric utility's share of Palo Verde's capacity will be 390 MW.

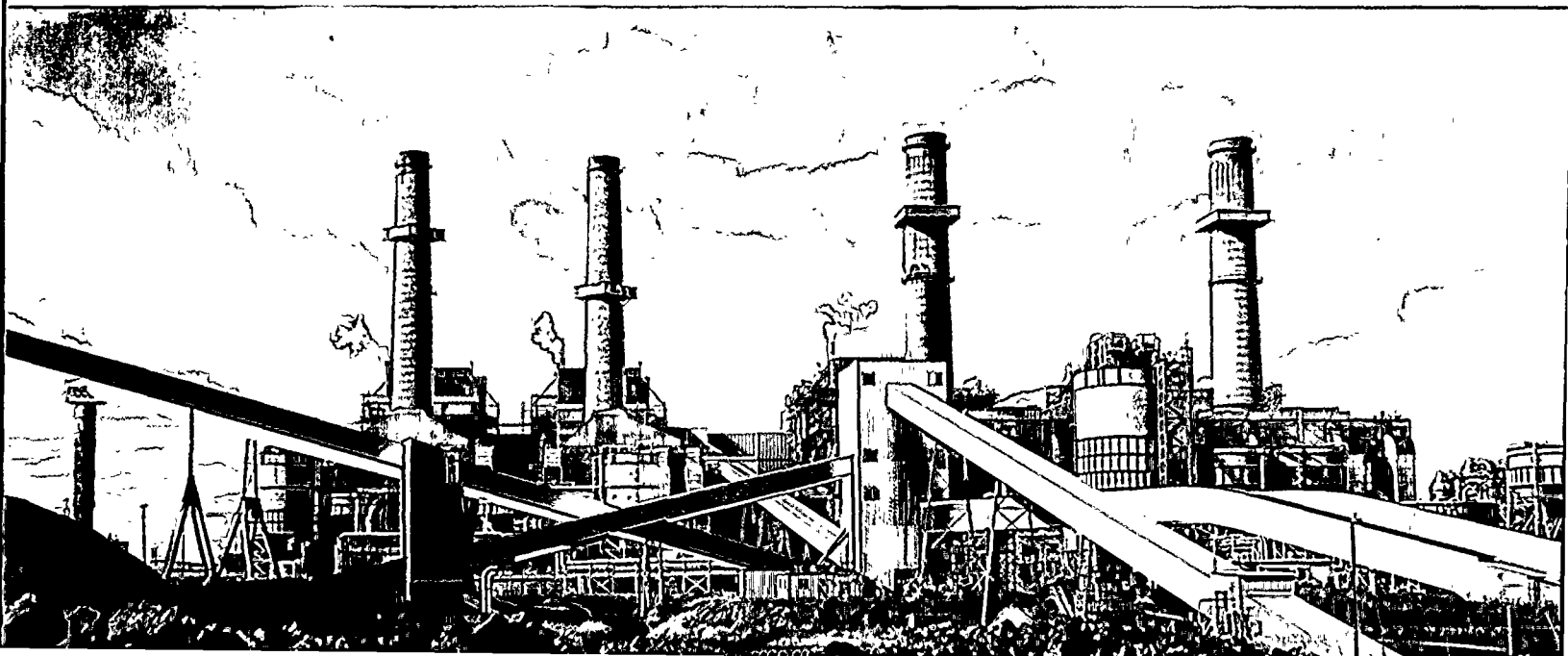
our service area is higher than the national average, but remains lower than previously experienced and forecasted. This is largely the result of a sharp decline in industrial loads, primarily the mining industry and delayed operation of the microchip industry, and less dramatic growth in the "sunbelt"

Changing market realities require new regulatory policies

As competition becomes a stronger force in our industry, the role of regulation must change.

The new realities we face include: (a) lower than forecasted growth in our region and primary service areas leading in the short-term to regional overcapacity in generation; (b) the need for transmission facilities able to serve distant markets; (c) aggressive energy pricing; and, (d) the need for innovation and information in bulk-power system

Meeting the cost competition challenge

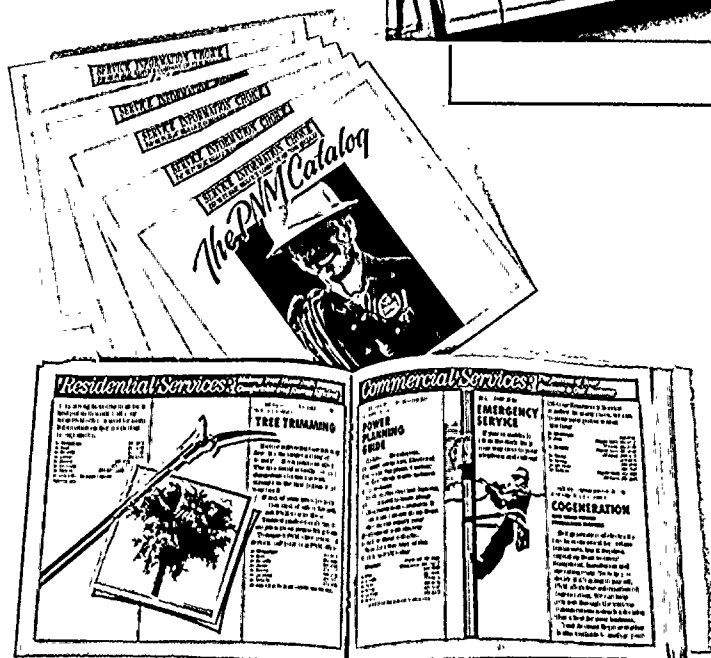
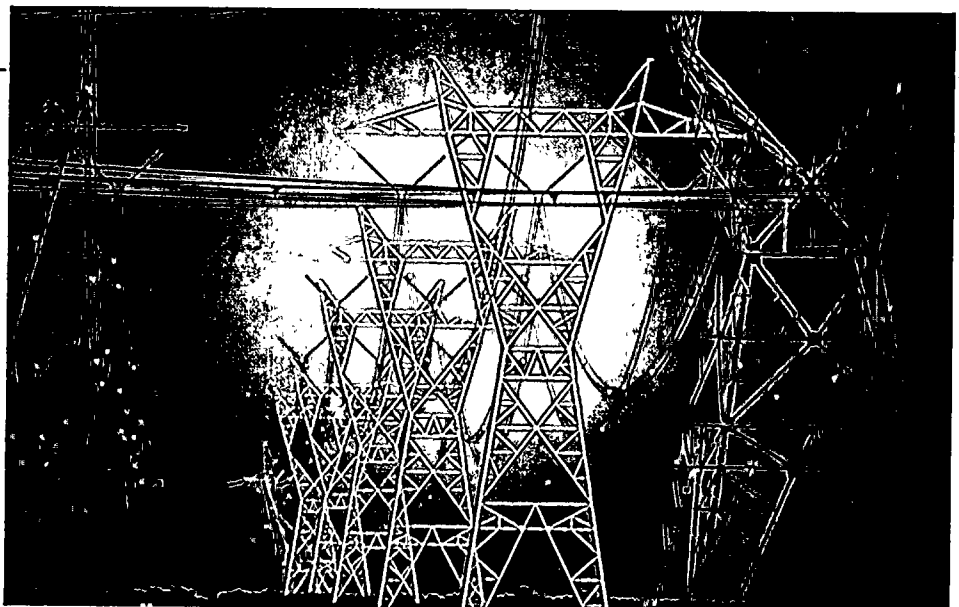




■ (above) Cathleen Andrasovsky, shift supervisor of San Juan Generating Station's water operations analysis laboratory, monitors water quality in the plant's boilers and cooling towers.

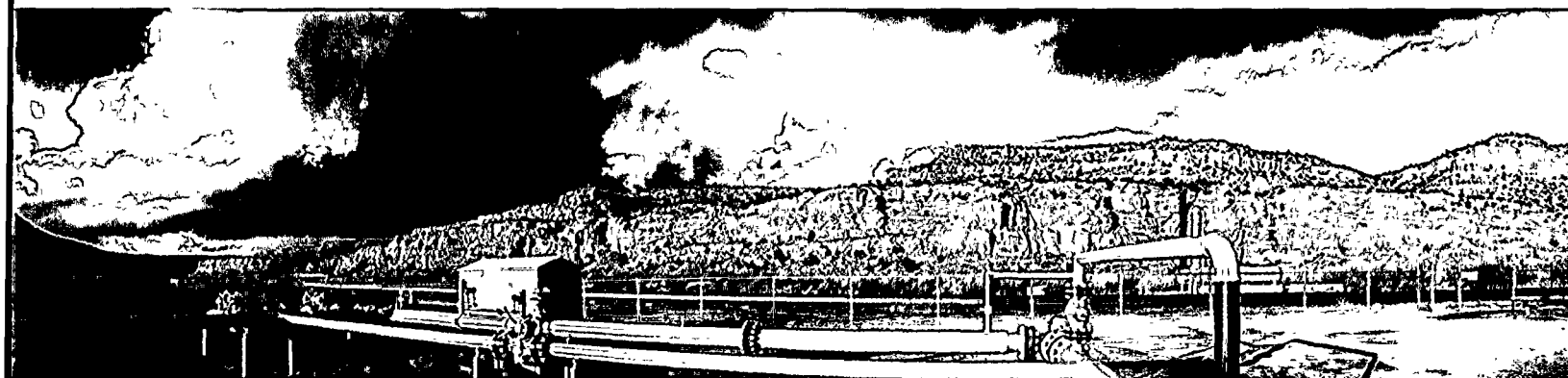
■ (left) As acid rain increasingly becomes an issue of national concern, we can point with pride to the coal-fired San Juan Generating Station. San Juan's pollution control facilities reduce air pollutants to levels more stringent than those considered as effective acid rain control elsewhere in the nation.

■ (below) Service should be customer-convenient! Our innovative "PNM Catalog" offers services, facts, and ideas to retail electric customers. Throughout 1986, we established neighborhood customer service offices, including one in an Albuquerque supermarket (right).



■ (top) Several 500 kV lines emanate from Palo Verde, connecting to distant markets. To further improve our access to those markets we are exploring options for acquiring additional transmission facilities.

Gas utility operates in a more competitive environment



Two years ago PNM acquired Gas Company of New Mexico, the largest natural gas utility in the state and the supplier for most state residents.

We buy natural gas from many independent producers through gas gathering operations and from pipeline companies, process that gas for home and business use, and sell it to retail customers in Albuquerque and most of New Mexico.

Abundant supplies nationwide have forced change in the natural gas industry, at least for the near-term. Some of our responses to competition at the wellhead, city-gate, and burner tip took place in 1986. More are planned in 1987. But Gas Company's transition from a traditional gas utility to a more competitive service company requires:

- greater sensitivity by regulators to the changing marketplace;
- more flexible gas supplies;
- improved interstate pipeline arrangements; and,
- improved marketing flexibility.

Market-sensitive regulation is needed now

Federal and state regulations now promote "contract carriage" of gas owned by others. Under contract carriage, a consumer buys natural



gas directly from suppliers and arranges for transportation and delivery by a carrier such as Gas Company.

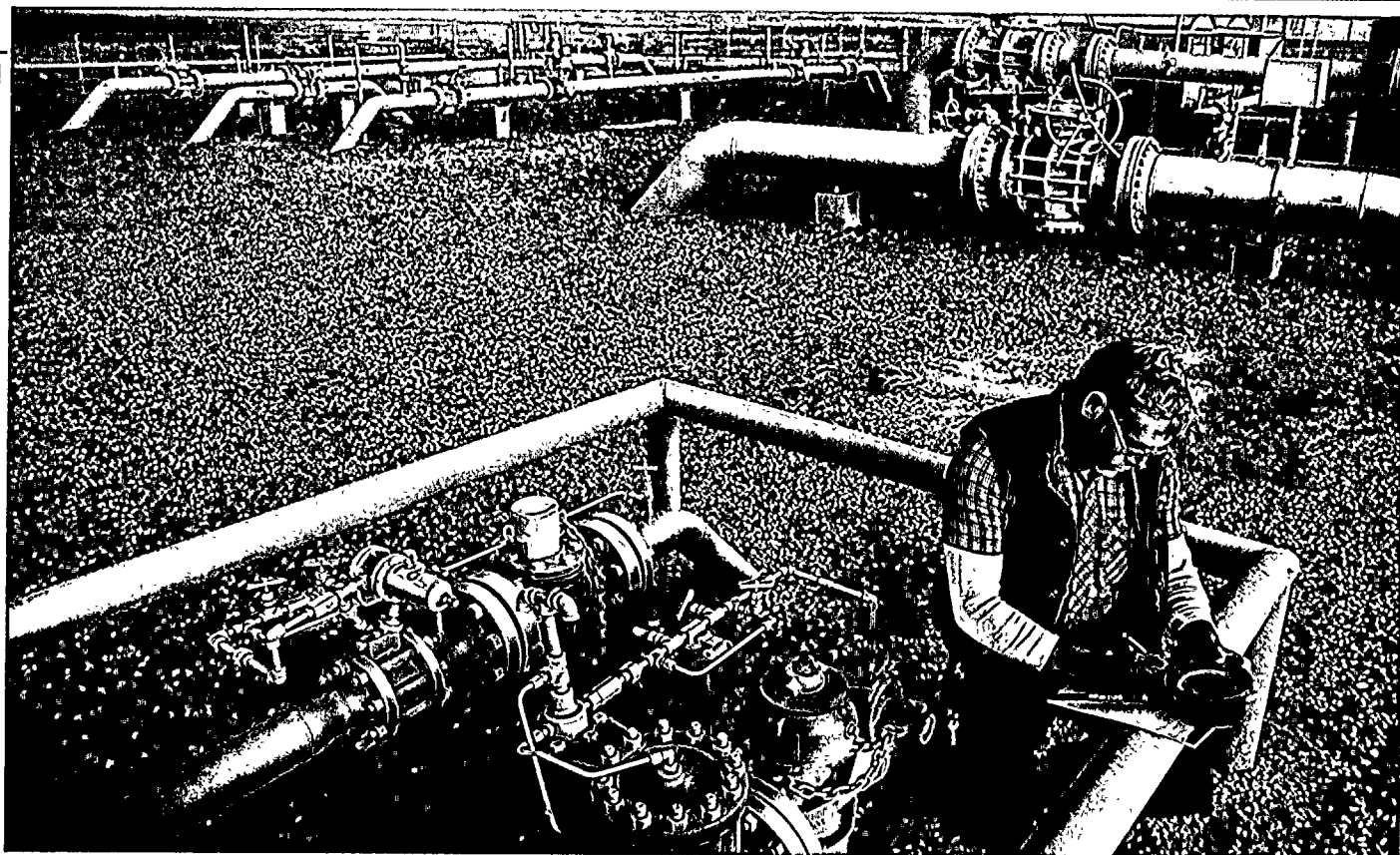
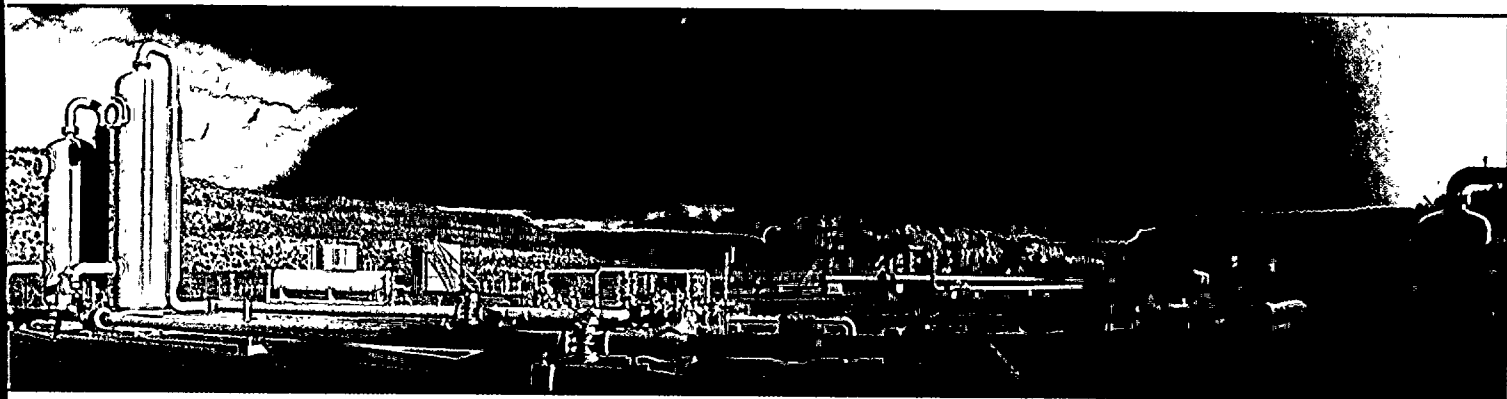
As an example, some customers now buy gas on the "spot-market" at a price lower than our system supply price. Their assurance of supply is limited to days or months. But these customers still expect our system supply to be available as back-up at no extra cost. As a result, Gas Company has a supply of gas, previously contracted for with producers, that it is now unable to sell to another customer. We believe the state should allow separate rates for this back-up service or relieve us from the obligation to contract for and hold reserves for carriage customers.

We also believe it is important to the Company, its owners, and cus-

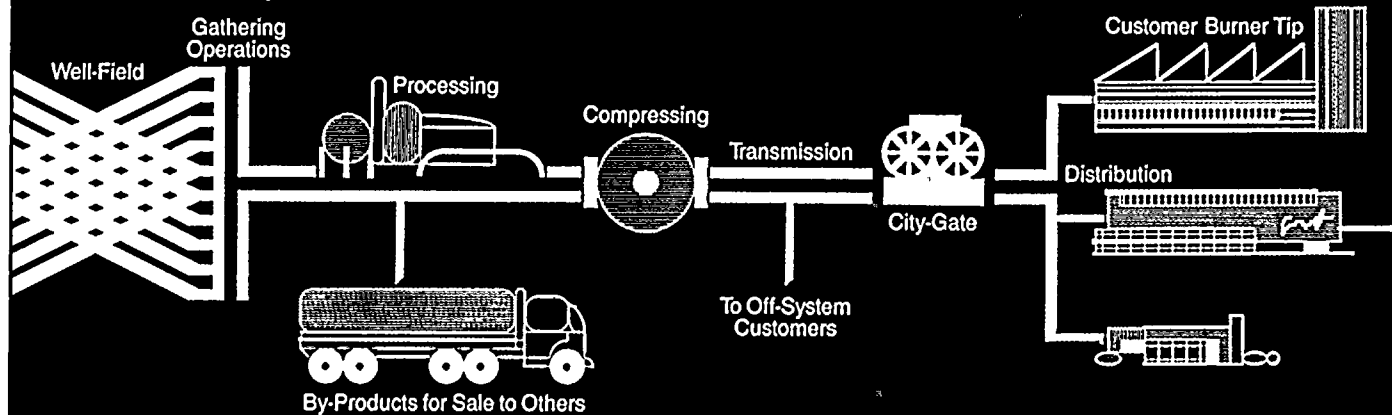
■ (top) It's a long journey by pipe from the gas well to the customer. The Dogie Canyon Compressor Station—19 miles from the nearest paved road—is home to six gas utility employees and their families. This and similar stations increase a pipeline's pressure to transport gas to distant distribution systems and interstate markets.

■ (above) John Ackerman, president of Gas Company of New Mexico (right), and Buster Orbison, manager of gas purchasing, met throughout the year to discuss the progress made in renegotiating gas contracts with well-owners. Between December 1984 and December 1986, our customers saw their cost of gas decline 33 percent as a result of the utility's efforts and lower market prices.

■ (right) Larry Thompson, electronics technician, maintains Albuquerque's city-gate. City-gates mark the transition from the gas utility's transmission system to its distribution system.



From Well to Burner Tip: How Natural Gas Gets to the Customer

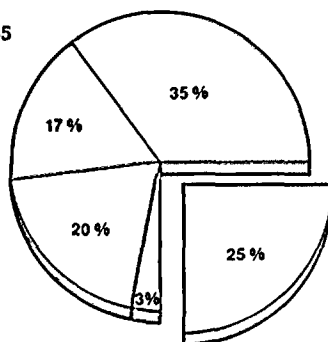


Market characteristics of gas are analyzed from gathering to end user

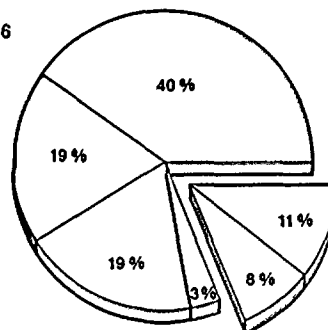


Gas Delivered by Customer Class*

1985



1986



☐ Residential ☐ Sales for Resale
☐ Commercial ☐ Transportation & Brokerage
☐ Other Retail ☐ Industrial

*Includes decatherms sold by Gas Company and decatherms transported for others by Gas Company under contract carriage.

■ (above) Sales to industrial customers in 1986 have decreased significantly, while a new customer class—transportation and brokerage is emerging.

■ (above) D. A. "Zan" James, vice president of marketing, rates, and regulatory affairs of Gas Company (center), and Brian Jeffries, manager of marketing for gas gathering company (right), discuss final details of an off-system gas sale with Dan Gibson, vice president of fuel resources, of San Francisco-headquartered Pacific Gas and Electric Company. Off-system gas sales are an increasingly important market outlet.

tomers for rates to be instituted for franchise residential and commercial customers who do not have these choices, and other rates for those larger customers willing to risk service interruption in exchange for a lower rate.

Gathering provides our supply

During 1986, we concentrated on stabilizing both supply and demand for our natural gas.

We renegotiated many contracts with natural gas well-owners. In doing so, we improved the characteristics of our gathering operations especially our mix of long-term, short-term, and "spot-market" purchases. This helps to assure us an ample supply at competitive prices. We are also working to improve our communication with gas well-owners. Our publication, "GCNM Pipeline," is one of those efforts. We work

jointly to improve their sales, and, as a result, improve our sales.

To encourage customers to stay on our system, our gas must be competitively priced. We began developing a computer model of our entire gas supply system that will help assure that we have the right quantity of gas available at the best price at all times. By matching the characteristics and costs of our supply contracts with the characteristics and price expectations of our customers' demands, we can reduce our customers' cost of gas.

Processing is required before gas is shipped to markets

We became an operator of a gas processing company in 1986. Processing removes liquid by-products like butane and propane before putting natural gas into pipelines. The liquid by-products are sold to others.

Pipelines: connections to retail and interstate customers

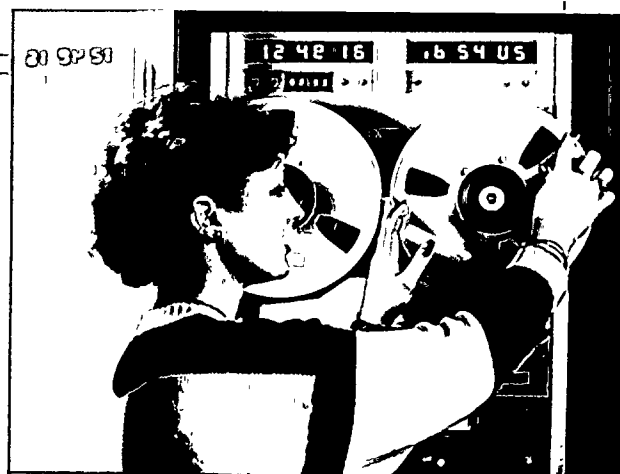
We are seeking better ways of using our pipeline assets. One option is to secure interstate transportation paths to the out-of-state marketplace using other companies' pipelines. Another option is transporting gas belonging to others through our pipelines in addition to our New Mexico customers' gas.

In the meantime, new trends in regulation and competition have dramatically changed our markets. (See charts at left.)

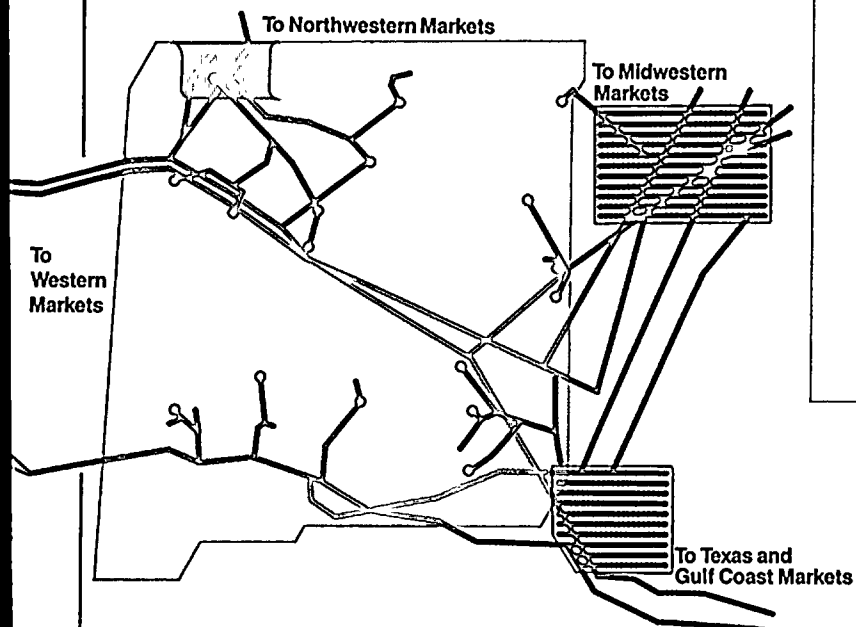
Distribution: improving service to individuals

We recognize the importance of serving the needs of individual customers and in 1986 we made major changes to improve service to customers.

For example, our surveys indicated that many customers found us difficult to reach. We responded by installing a new computer-based telecommunications system and increasing the size of our customer service staff.



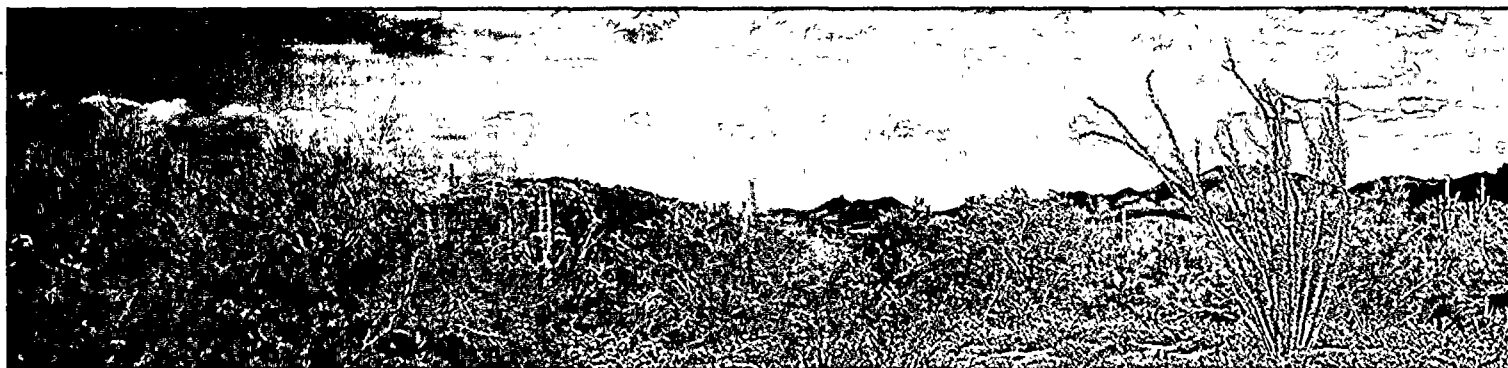
■ A computerized telephone system and a larger staff make us more responsive to customers. Diana Morris, customer consultant manager, discusses a caller's concern with a member of her staff (top). Peggy Pierce retrieves a tape recording of customer calls for use in evaluating an employee's telephone skills (above).



Regional Gas Utility System Map

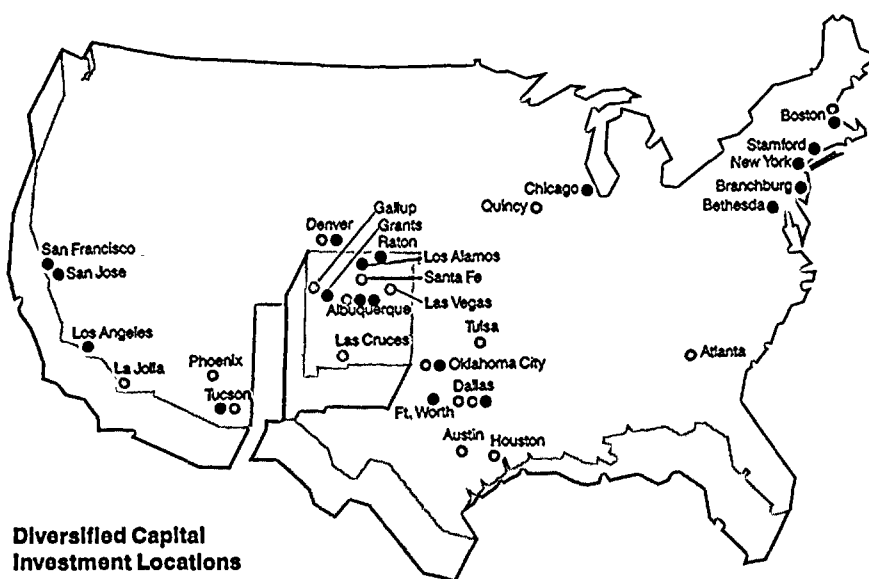
- Gas Company of New Mexico System
- Gas Company Gathering Wellfield Area
- Gathering Company Wellfield Area
- Other Transmission
- ▨ National Pipeline Interconnection Area

Diversified capital group invests for future



■ (above) Falcon Ridge, near Phoenix, is a new development of Bellamah Community Development, a Meadows investment. Falcon Ridge is Bellamah's 30th project. Real estate is one of Meadows' three areas of investment emphasis.

■ (left) Jim Jennings, president and chief executive officer of Meadows (right), and Bill Hunt, chairman of the board, president, and chief executive officer, of Alliance Telecommunications Corporation, a Meadows investment, at an Alliance manufacturing plant in Atlanta. Alliance manufactures radio paging and voice messaging equipment.



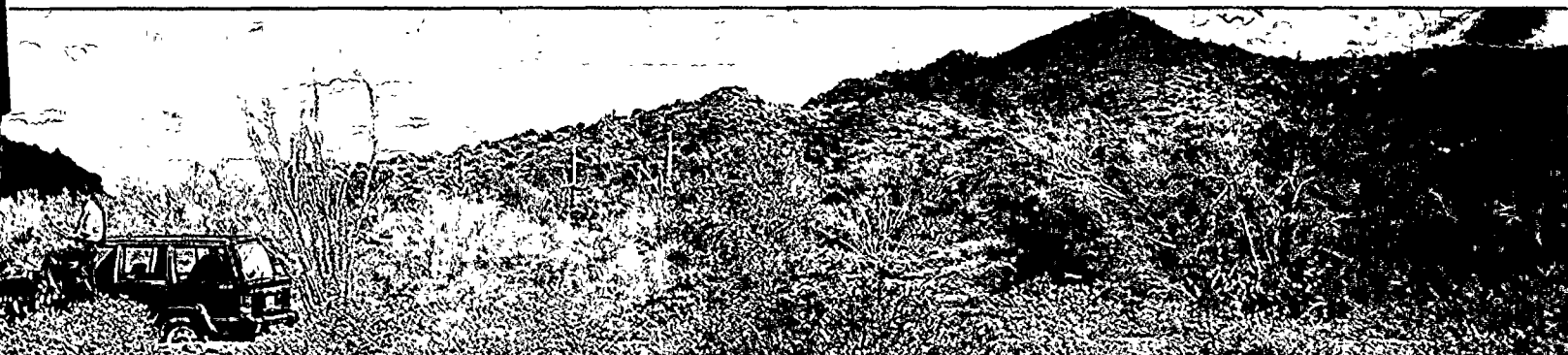
Diversified Capital Investment Locations

- Telecommunications Manufacturing
- Financial Services
- Real Estate Development
- Fiberboard Plant
- Venture Capital

Through Meadows Resources, Inc., we manage nonutility investments, primarily in three industries offering long-term growth and profit potential:

- telecommunications manufacturing;
- financial services; and,
- real estate development.

During our first year in telecommunications, we acquired interests in several companies. These companies generated more than \$50 million of sales in 1986, giving Meadows an international presence in a specialized market of designing, manufacturing, and marketing equipment for



■ (above) Jack Nicklaus and Roger Rankin, vice president of Meadows, discuss Mr. Nicklaus' designs of two 18-hole golf courses for The Ranch at Santa Fe. Initial development is under way for The Ranch at Santa Fe and its executive forum, The Santa Fe Center.

■ (left) Bill Black, president of Montaña de Fibra, inspects the plant's fiberboard press, which produced a company record of high quality medium-density fiberboard in 1986. The Las Vegas, New Mexico plant manufactures wood panels that are principally used in furniture cabinets. MdF's markets reach as far as Italy and Taiwan.

radio, cellular, voice storage and forwarding, and paging uses. Our desire is to provide to a common customer group components from the phone line to the antenna. We are pursuing additional investments in this area.

Meadows is part owner of a financial services subsidiary which continued to grow in real estate financing and investment activities. Its savings and loan in Chicago grew from \$215 million to \$310 million in assets. They are expanding into other financial services, including mortgage servicing, and are evaluating insurance investments.

Our real estate projects generated

\$91 million of revenues in 1986, and were profitable. Most of our real estate projects involve "pre-development" of affordable new residential and commercial areas near major cities in the Southwest.

Meadows' investments result in utility load-building

Meadows' new expanded program of direct business investments in New Mexico is designed to contribute to New Mexico's economic diversification and increase economic activity in PNM's utility service areas:

■ The Montaña de Fibra fiberboard plant had revenues of \$16 million in 1986, but continued to operate at

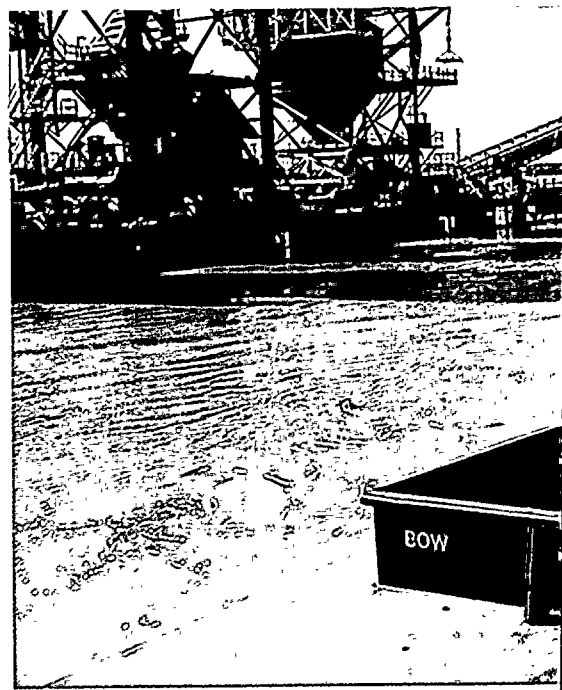
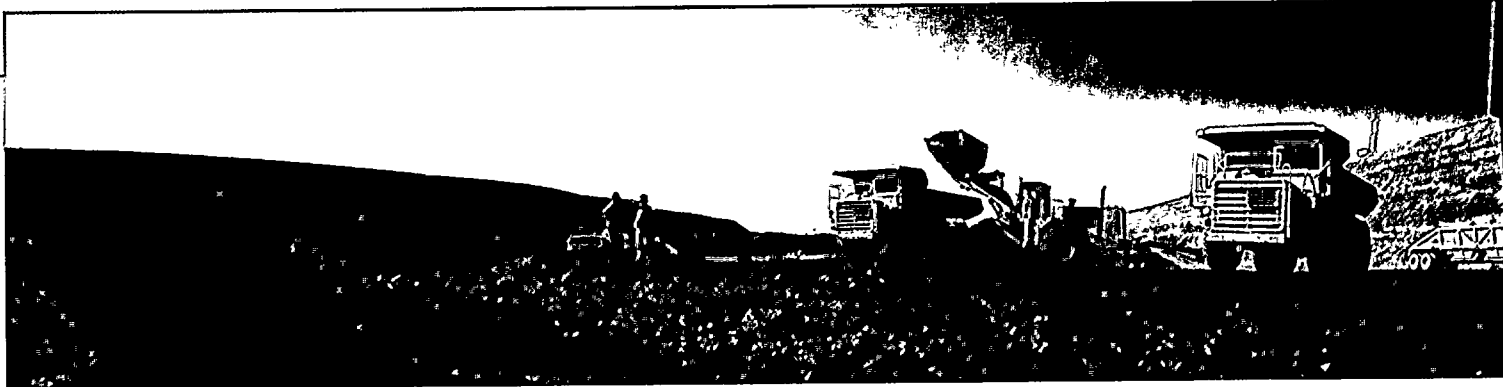
a loss. Worldwide shipments of medium-density fiberboard were strong, but prices were weak. Even so, this plant contributes substantially to the local economy.

■ Investments in small New Mexico venture capital companies.

■ Investments in New Mexico real estate development projects.

■ The Ranch at Santa Fe and its center of learning—The Santa Fe Center, where executives from around the world will gather for seminars and conferences to explore international issues.

Natural resources unit improves operations



■ (above) Bob Rountree, chairman of Sunbelt (seated), and Al Robison, president and chief operating officer of Sunbelt, make the strategic decisions necessary to manage a portfolio of natural resources operations.

Since 1979 our natural resources subsidiary, Sunbelt Mining Company, Inc., has grown from a small coal mining operation into an organization that explores, acquires, develops, and markets mineral and energy resources in the Southwest, as well as in new markets in the Midwest and Florida.

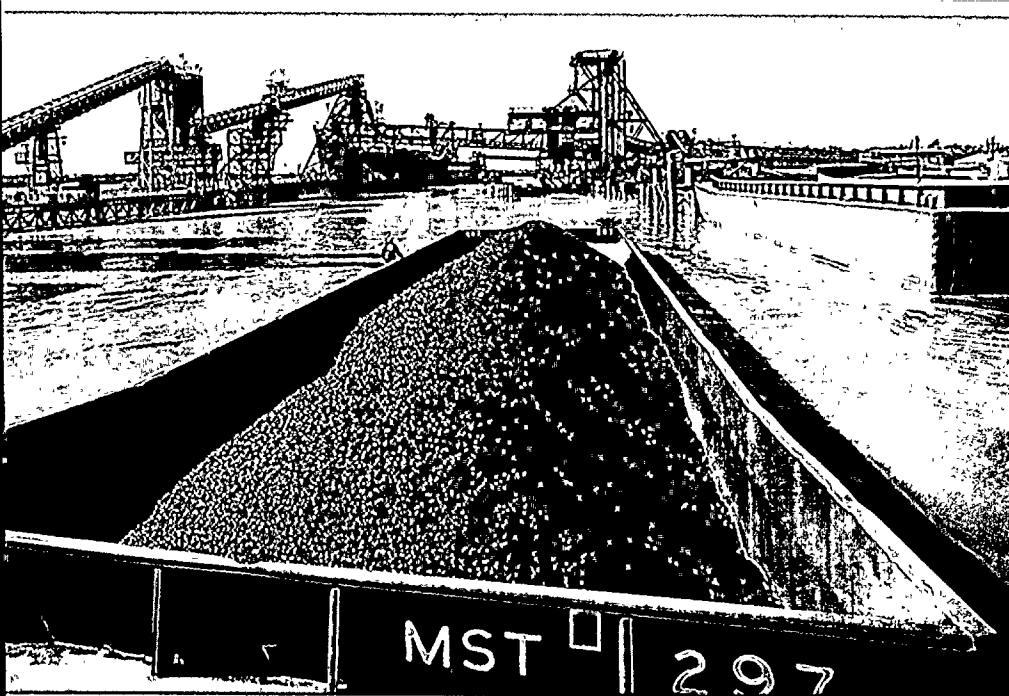
Coal is mined in New Mexico and Oklahoma

Sunbelt's major New Mexico property is the De-Na-Zin/Gateway coal mine in northwestern

New Mexico. This mine produces 225,000 tons per year for the San Juan Generating Station, under a supply contract which expires in 1991.

Additionally, Sunbelt—along with Arch Mineral Corporation—controls over 500 million tons of low-cost, surface-mineable coal adjacent to the De-Na-Zin/Gateway operation. Sunbelt and Arch Mineral are working together to develop these resources for the proposed Dineh Power Project.

A subsidiary of Sunbelt owns and



■ (above) Sunbelt's De-Na-Zin/Gateway coal mine near Farmington, New Mexico, produces low-sulfur coal for the San Juan Generating Station.

■ (left) Contract barges move coal from our Oklahoma mines to a utility customer in Florida.

operates one of the largest surface coal mining operations in Oklahoma. In 1986, operations were centralized from several Oklahoma sites and the mines' equipment was improved. We could also benefit from a new Oklahoma law requiring Oklahoma utilities to buy at least 10 percent of their coal from Oklahoma mines.

Precious metals properties are slated for sale

After a reassessment of their precious metals holdings, Sunbelt's subsidiaries decided to reduce

investments in this industry.

New developments add to Sunbelt's role

Totah Power Development Company, Inc. was recently organized as a Sunbelt subsidiary to provide the vehicle for PNM's participation in the Dinah Power Project. A gas processing company was purchased in December. Natural gas is processed at this operation and liquid by-products are removed and sold. These two developments represent new areas of investment emphasis.

NATURAL RESOURCES SITES

Coal Properties

De-Na-Zin/Gateway Mine
Near Farmington, New Mexico
Rogers III Mine
Near Tulsa, Oklahoma

Gold Properties
Northern California
Western Nevada

An expression of thanks



■ (top) Albuquerque, New Mexico's largest city, is home to many PNM employees.

■ (above) Ray Hoffman proves that you don't have to live in a city or town to be a volunteer. Supervisor of the Gas Company's isolated Dogie Canyon Compressor Station, Ray volunteers as a grounds keeper and Santa Claus at the Largo Canyon School. (But don't tell the school's ten kids!)

■ (right) Sherry Leeson tutors English by phone to high school students in a program established by an Albuquerque high school in 1986.



As chairman of this corporation, I am exceptionally proud of our employees' dedication to service excellence—both on and off the job.

In these two pages we share with you just a few examples of our many outstanding employees. Through their efforts, the communities that we call home are a richer place in which to work and play.

Your Company encourages employees to become active, vital members of their communities. As an example, a Company-sponsored program, Volunteers Interested in People, asks for—and receives—employees' help in a wide range of

volunteer service activities. More than 230 employees said YES in 1986 by helping people with disabilities, working in hospitals, judging science fairs, and supporting senior citizens' activities. The VIP's Weatherization Program was a major undertaking this past year. In replacing broken windows, in weather-stripping and caulking around doors and windows, and making other energy conservation repairs, the VIP's made many needy Albuquerque residents warmer during the winter months.

Jim Leeson



■ (top) Santa Parra and Paul Schwarz served as key organizers for the 1986 Greater Albuquerque United Way Campaign. Through their hard work and the generosity of fellow employees, they helped raise more than \$234,000.

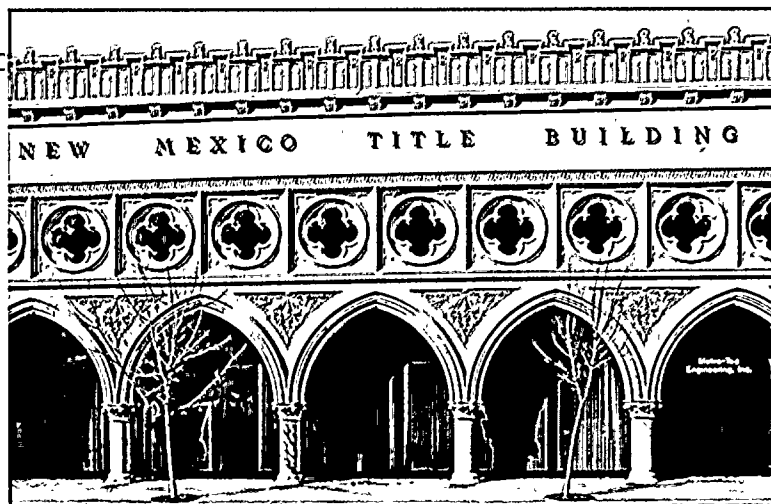
■ (above left) Mana De Rios shares her time with Albuquerque's non-profit blood bank, the Junior League, and the Volunteer Center of Albuquerque, which matches skills of volunteers with the needs of local non-profit organizations. ■ (above right) Mike McEuen wears several volunteer "caps" Mike is involved with the Red Cross, Project Share, Health Care for the Homeless, and the Feed the Hungry Program in downtown Albuquerque.

■ (from left to right) Fred Willer, Cheryl Wilson, Jeff Archuleta, and Tim Gordon are members of the San Juan Generating Station's volunteer fire company. Fire company volunteers are on call around the clock.

■ (right) Ron Edgington, on behalf of the Cystic Fibrosis Society, ran 3,150 stairs in two hours in the annual "Pit Climb" at the University of New Mexico Arena.



A good place to do business—A good place to live

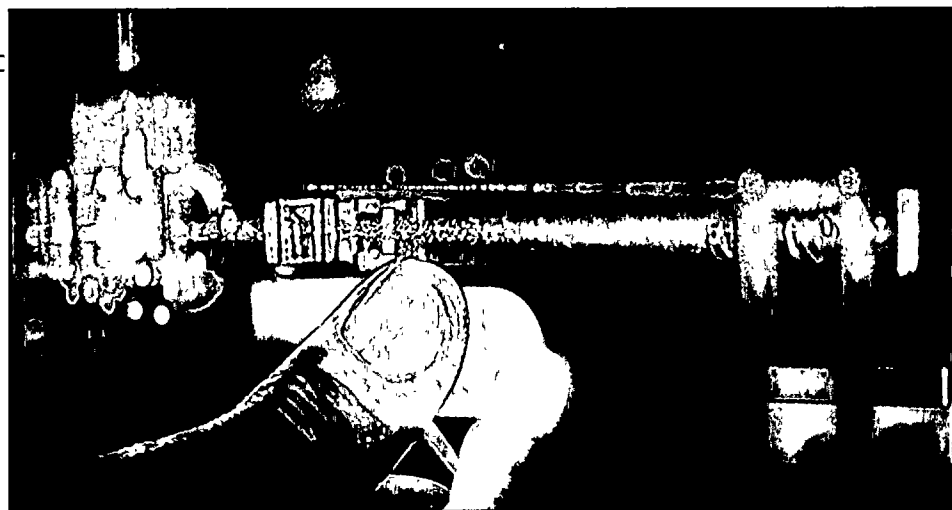


■ (top) New Mexico is a haven for America's retirees, who find a variety of housing as well as a mild climate. These apartments are "The Islands of Rio Rancho" located west of the Rio Grande near Albuquerque. Rio Rancho is one of the fastest growing areas in PNM's service territory, attracting retirees and first-time home buyers.

■ (above) Albuquerque's tribute to the Doge's Palace of Venice, the New Mexico Title Building, underwent a major renovation in 1982 which restored its arches and intricate carvings. The building, listed on the National Historical Register, is just one of many striking office buildings in downtown Albuquerque.

■ (above right) Once unique to the Southwest, New Mexico's culinary specialties are now available nationwide. Tortilla chips, green chile, and spicy condiments are produced at the family-owned Bueno Foods, in Albuquerque's south valley. Pictured here are Joseph Baca, chairman of the board, and Jackie Baca, president.

■ (right) The Biophysics Group at the Los Alamos National Laboratory has advanced the technology of Flow Cytometers. Using lasers to detect disease, and in particular, cancer, this technology has spurred international attention and collaboration. New Mexico is home to two of the nation's largest centers of scientific research: Los Alamos National Laboratory and Sandia National Laboratory in Albuquerque.





Our corporation was born, and continues to grow, in a provocative land called New Mexico. It is the 47th of the 50 United States, but it is also a state of mind: There is a constant, underlying excitement about what we find here—and what we are stimulated to seek.

It is a good place to do business; a good place to live.

On these pages PNM salutes the businesses, the culture, and the arts of New Mexico...a place we're very proud to call home.

From the beginning, many of those who have explored New Mexico have

also stayed. First the Anasazi...then Native Americans...the Spanish...the new American ranchers, farmers, and merchants. More recently, the scientists, engineers, and entrepreneurs who followed the sun to these exciting new horizons.

New Mexico is a world-famous incubator of ideas in science and technology, with one of the highest concentrations of doctorate degrees in the 50 states.

All have found the excitement of this land. They see its beauty as well as its opportunity, and look to make the most of both. They

■ (above) General Electric's TF 39 jet engine powers the C-5B, the largest aircraft in the world. Parts for these and other engines are made at GE's aircraft engine plant in Albuquerque.

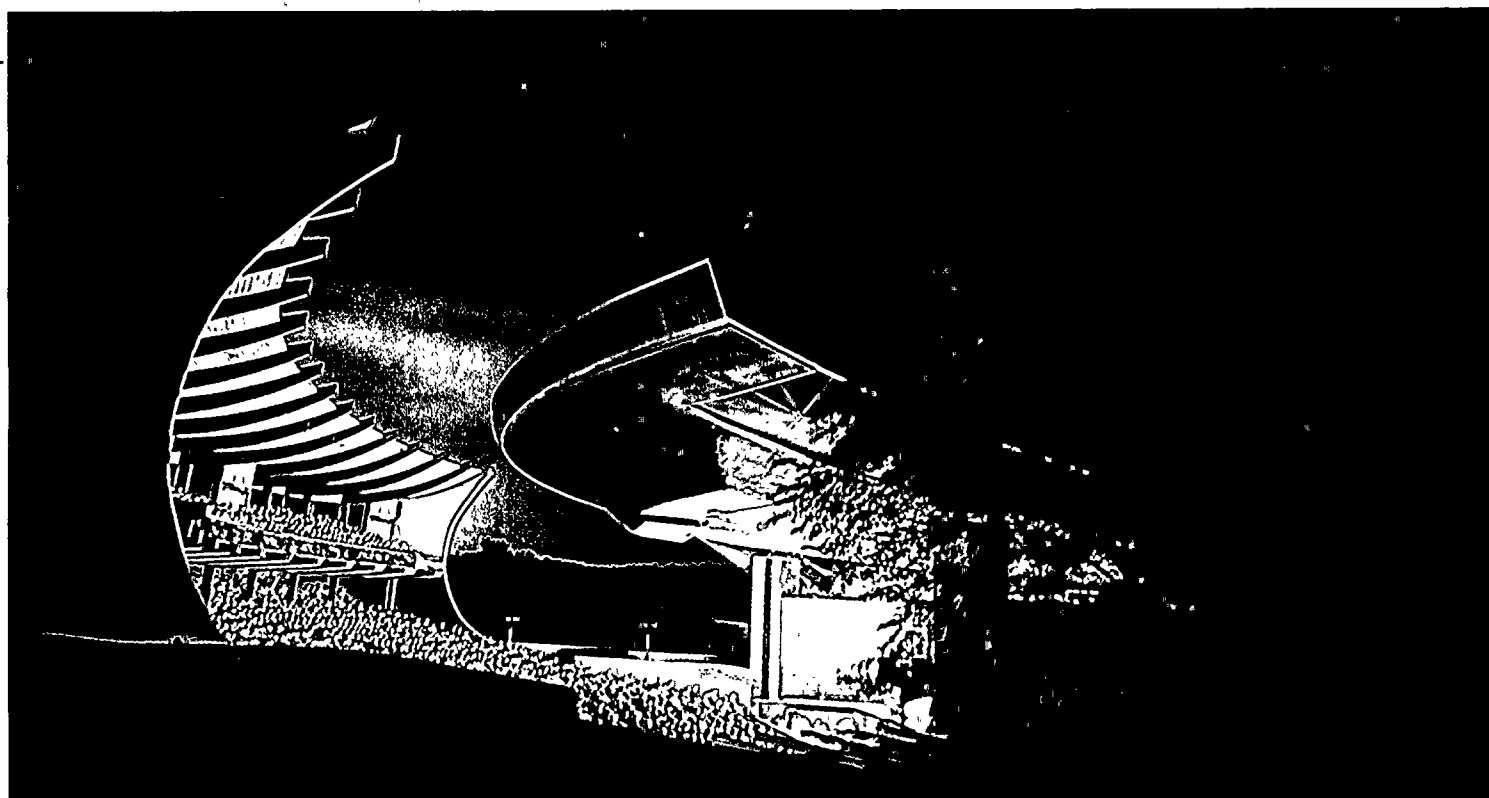
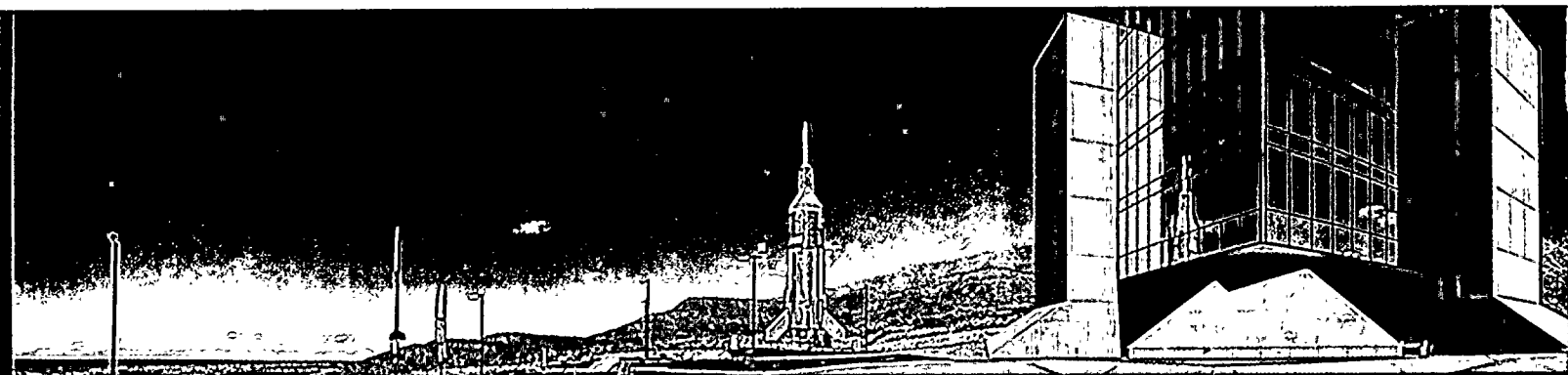
■ (above left) One of only two such plants in the nation, this Greyhound plant at Roswell manufactures buses that will travel the world's highways.

dream big—and work hard.

Their work involves a variety of outputs, from tortilla chips to computer chips. Buses. High-tech medical equipment. Lumber and fiberboard. Gas, oil, and minerals. And hundreds of other products, services, and ideas.

PNM serves nearly all of the businesses and institutions pictured here. We're proud that our reliable, affordable service makes it possible for these people and their organizations to work toward their visions of growth, prosperity, and "the good life" that New Mexico offers.

"New Mexican" means unique



■ (top) New Mexico's International Space Hall of Fame at Alamogordo offers a look at yesterday—and a glimpse of tomorrow. The museum is located near White Sands Missile Range, home to much of the nation's rocket research.

■ (above) The architecturally striking Santa Fe Opera attracts many of the world's most talented artists. Renowned for imaginative stagings of traditional productions of Mozart, Wagner, Verdi, and Puccini, the Opera has held world premiers of many contemporary operas.

New Mexico's blend of three great cultures has created a culture all its own—"New Mexican"—rooted in our peoples' distinctively different worlds of yesterday, reflective of the land we live in today, sharing the hopes we have for tomorrow.

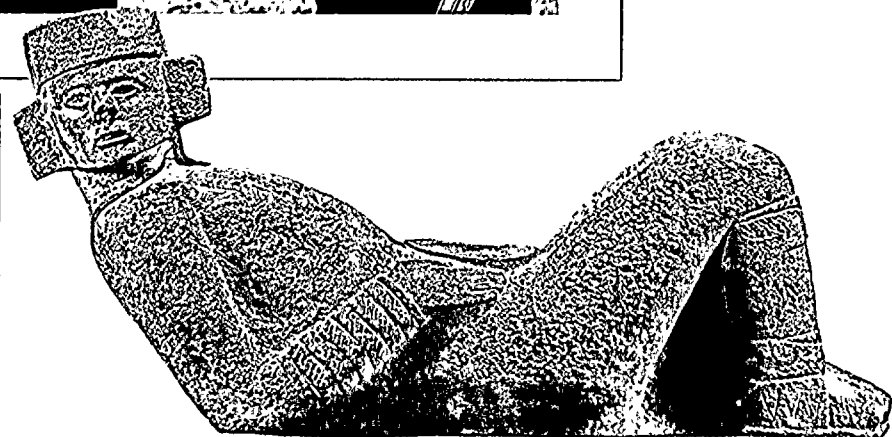
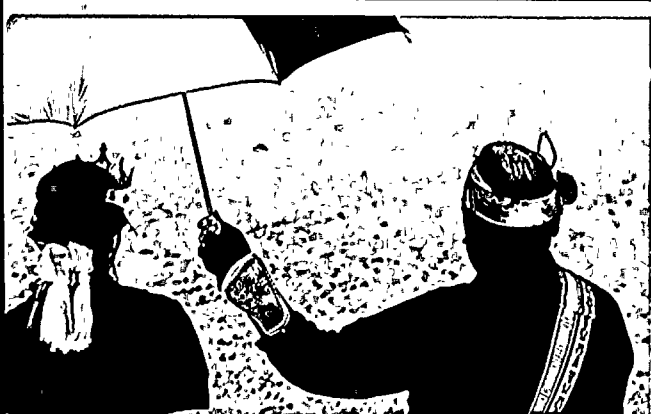
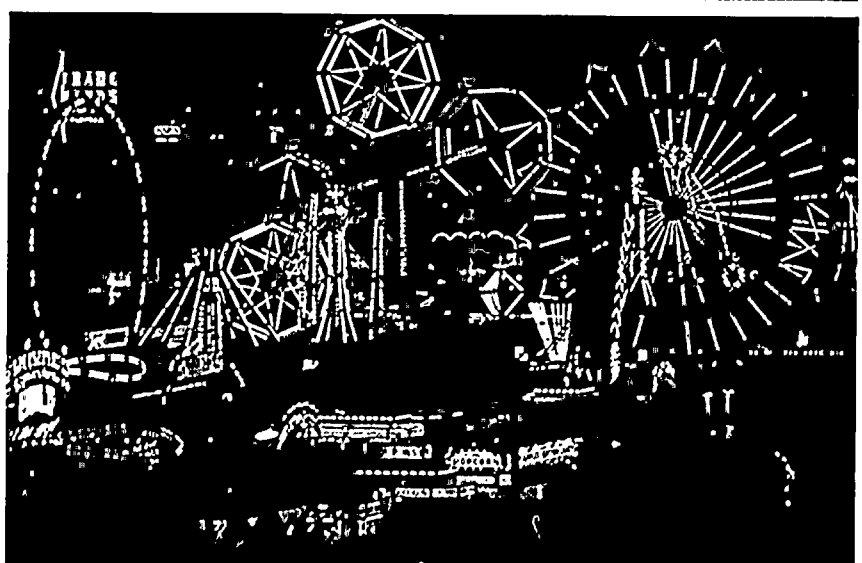
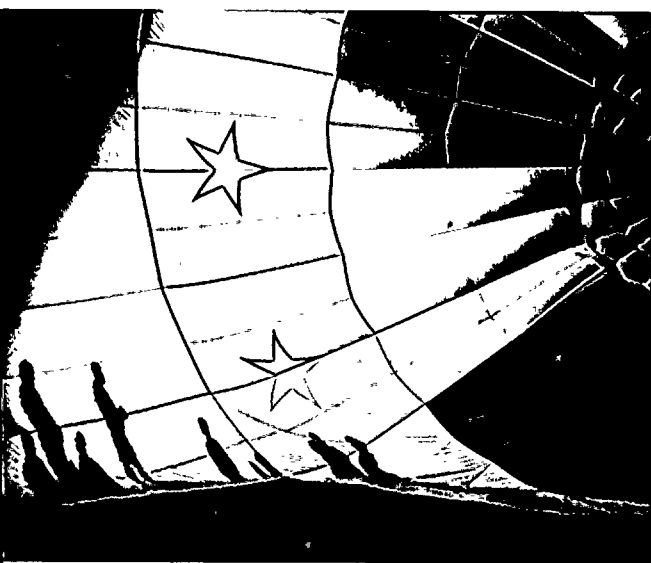
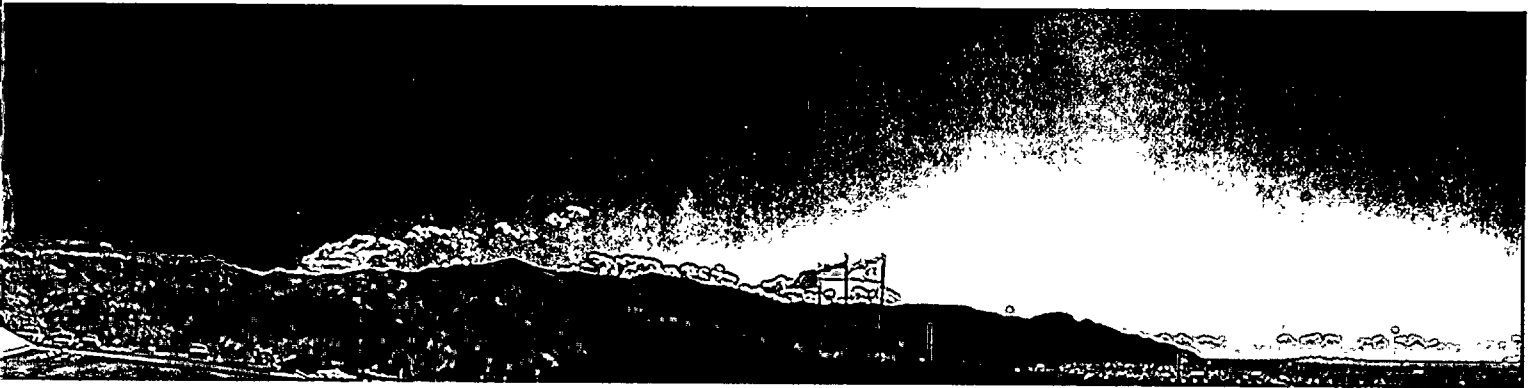
Perhaps because much of our land remains undisturbed, we are more conscious of our past than are the citizens of many other states.

New Mexico is home to many

enchanting museums. Recently, The New Mexico Museum of Natural History was dedicated. It is the first natural history museum to open in the nation in 50 years.

Our colorful history was prelude to our diverse present. The places, things, and events pictured here represent our varied lifestyle.

We share this good life within a dynamic economy, and welcome a future built upon a unique way of life.



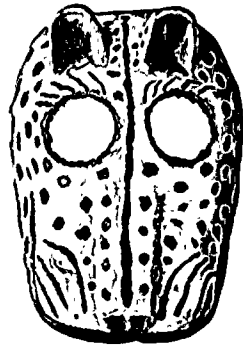
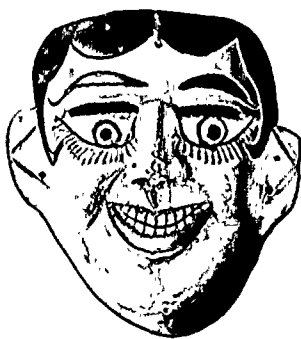
■ (above left) As many as 400 colorful hot-air balloons ascend during the International Balloon Fiesta every October. Participants from nearly 40 countries gather for this event in Albuquerque, the largest of its kind in the world.

■ (above) New Mexico's State Fair is among the nation's top five in terms of attendance, with one of the largest cash purses on the professional rodeo circuit. Our electric utility helped plan a complete renovation of the fairground's electrical system in 1986.

■ (left) Indian dancers from all over the country come to the New Mexico State Fair to share their ancient traditions. These dancers are from Zuni Pueblo, one of New Mexico's 19 pueblos.

■ (below left) After successful showings in New York, Toronto, and other major cities, *MAYA—Treasures of an Ancient Civilization* has returned to The Albuquerque Museum. Organized and assembled by the museum, this rare collection of Mayan artifacts was gathered with the help of Mexico, Guatemala, and Belize.

Art born from the inspiration of a land and its people



Layening 1; by Evelyn Rosenberg

Start with a land famous for its diversity: Natural features unique to the Southwest, like arroyos and mountains. Plants from every life zone: Cacti, evergreens, sagebrush, oak trees, yucca, and alpine wildflowers. Endless skies, etching into our memories their blazing sunsets and star-studded midnights.

Add three cultures, each seeking to preserve its heritage while also discovering—and blending with—

the others.

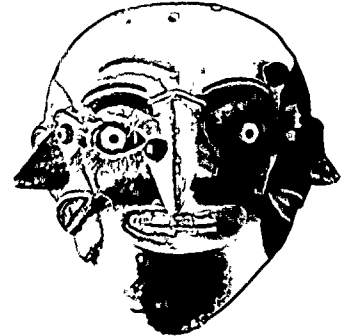
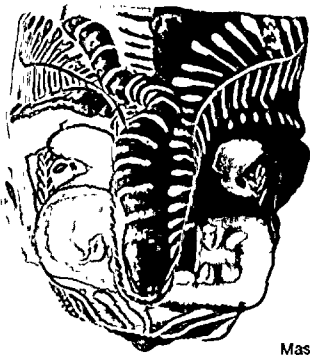
The result is a society of artists and art-lovers...also known as New Mexico.

It's doubtful that any other state has as many career artists per capita, "Sunday painters," galleries, or collections.

From the rock-paintings of ancient peoples to the "detonography" of today, our art has reflected the variety of this place and its peoples.

Every form of art has found a home in New Mexico. Indeed, some of our place-names are almost synonymous with art: Taos. Santa Fe. Albuquerque. But in almost any part of the state, at almost any time of the year, one can view art, as well as study, buy, sell, and even live it.

The art, like the place, takes on a million forms and hues. And PNM is proud to have a role in this exciting place, among these exciting peoples.

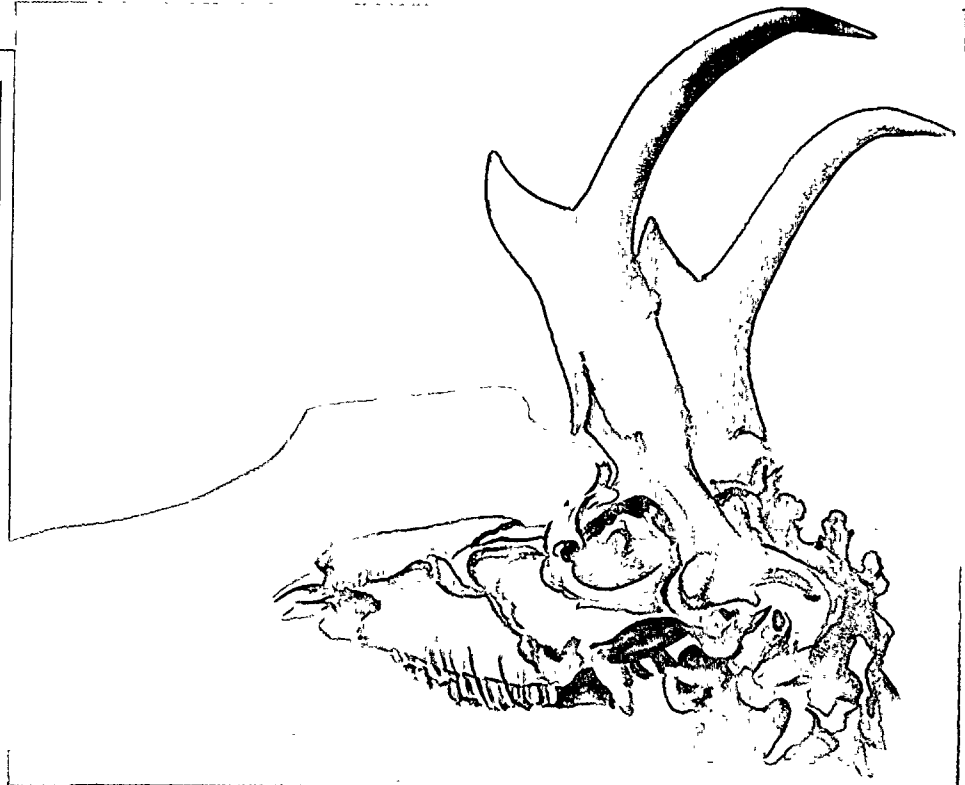


Mask photos by Sally Andersen Bruce/Courtesy of Museum of International Folk Art, Girard Foundation Collection and International Folk Art Foundation Collections, Santa Fe.

■ (above) These masks are among the many collections of traditional arts, antiquities, and folk arts housed in the Museum of New Mexico, a collection of five museums located throughout Santa Fe. (left to right) Clown Mask, "Tiger" Mask, Ceremonial Dance Mask, Negrito Mask, Tastoan Devil Mask, Morochino Mask by Ruperto Abraham, Moor Mask, all from Mexico; Mask with Three Faces from Bolivia.

■ (left) New Mexico, long a haven for the traditional arts, is equally hospitable to new ones. Albuquerque artist Evelyn Rosenberg developed "Detonography", which combines plaster casts, stainless steel plates, and sheets of plastic explosive.

■ (far left) One discovers the Santuario de Chimayo on the high road to Taos. With its simple lines and earthen tones, the chapel is a destination for religious pilgrims and a striking example of the Hispanic adobe architecture prevalent throughout the state.



Antelope Head With Pedernal; by Georgia O'Keeffe/Courtesy ACA Galleries, New York



■ (above) Painting by Georgia O'Keeffe, a major influence in 20th century American art and a long-time resident of Abiquiu, New Mexico. Life Magazine observed, after her death at 98, that she "loved New Mexico's stones, bones and clouds."

■ (left) Margaret Tafoya, of the Santa Clara Pueblo, and other Native American artisans continue New Mexico's heritage in a modern world. In the tradition of her ancestors, Margaret gathers her own clay from a nearby mesa before shaping, firing, and painting her nationally admired pottery.

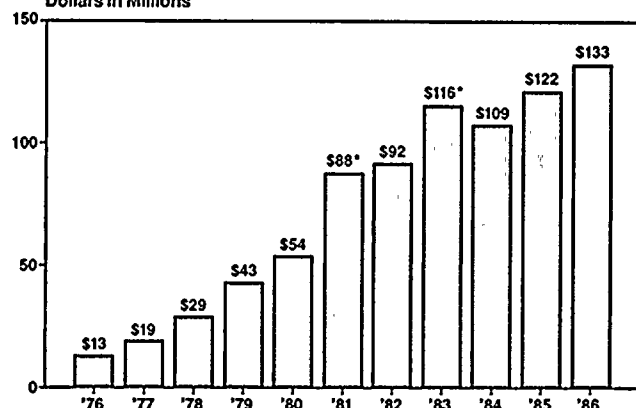
“ Our employees have demonstrated outstanding initiative in meeting challenges. They continued to slash costs, explore new ways to serve customers better, and develop new markets. ”

Financial Data and Consolidated Financial Statements

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Management's Discussion and Analysis of Financial Condition and Results of Operations

Net Earnings Applicable to Common Stock
Dollars in Millions



*Includes sale of retained economic interest in coal leases which contributed \$18.8 million and \$24.1 million to earnings, respectively, in 1981 and 1983

The following is management's assessment of the Company's financial condition and the significant factors which influence the results of operations. This discussion should be read in conjunction with the Company's consolidated financial statements.

The Liquidity and Capital Resources section and the Results of Operations section do not reflect any potential restructuring of the Company discussed under the Company's Response to Marketing and Regulatory Challenges section.

Liquidity and Capital Resources

Utility Construction Program Commitments Decline

With the commercial operation of the Palo Verde Nuclear Generating Station (Palo Verde) Units 1 and 2 in 1986, the Company's utility construction expenditures continue to decline relative to the levels experienced during the late 1970s and early 1980s. Over the next five years (1987-1991), the Company expects to spend \$576 million for electric, gas, and water utility construction. This projection includes \$42 million in "allowance for funds used during construction" (AFUDC), a non-cash item that reflects the Company's costs of debt and equity capital used to finance utility construction. The \$576 million projection also includes \$57 million for nuclear fuel.

Actual utility construction spending during 1986 and the Company's projections for 1987-1991 (in millions of dollars) are shown below:

	1986	1987	1988	1989	1990	1991
Cash	\$151	\$112	\$107	\$ 99	\$ 97	\$119
AFUDC	49	28	4	3	3	4
Total	<u>\$200</u>	<u>\$140</u>	<u>\$111</u>	<u>\$102</u>	<u>\$100</u>	<u>\$123</u>

These estimates are under continuing review and subject to adjustment.

Capital Requirements: A Five Year Projection

Capital requirements are met with a combination of externally-raised funds and internally-generated funds from operations.

The Company estimates its utility capital requirements for the next five years (1987-1991) at \$641 million. This total includes \$96 million that will be applied to the payment of long-term debt maturities and to the mandatory redemptions of preferred stock.

The level of internally-generated funds depends on rate relief granted by both the New Mexico Public Service Commission (NMPSC) and the Federal Energy Regulatory Commission (FERC). The level also depends on the Company's ability to sell significant amounts of additional power not currently under contract. The price that the Company will receive for this power is expected to be adversely affected by the existing soft market for wholesale and off-system power sales.

It is projected that the non-utility subsidiaries will provide a substantial portion of their capital requirements from internally-generated sources. To the extent that external debt financing may be required, such borrowings will be made independently by the subsidiaries from third-party sources and will be nonrecourse to the Company.

How will the Company Meet its 1987 Utility Capital Requirements?

The Company expects to meet its 1987 utility external financing requirements through the issuance of approximately \$12 million of common stock under the Company's stock plans, incurrence of short-term debt, and use of funds currently invested on a temporary basis. Stock plans previously provided a significant portion of the Company's capital requirements. It is anticipated that stock plans will no longer provide significant capital since, in the future, stock for the plans will principally be obtained from open-market purchases rather than from the issuance of new shares.

Liquidity

The Company's management measures liquidity in a number of ways in evaluating the Company's ability to maintain financial strength. Cash derived from operations is an important indicator. The level of cash and temporary cash investments, less short-term borrowings, is another. A third measure is the Company's ability to raise needed capital from outside sources.

The sale and leaseback of the Company's interests in Palo Verde Units 1 and 2 directly and indirectly influences the Company's overall cash position. The Company is required to make lease payments totaling \$84.6 million per year over the approximate 29 year term of these leases. However, the proceeds from the sale and leasebacks allowed the Company to reduce a significant portion of its highest cost first mortgage debt and preferred stock. (See the accompanying charts detailing the Company's capital structure). The Company has saved \$46.7 million in interest and dividend payments annually, has reduced the need for short-term borrowings, and has increased interest income from temporary cash investments.

The Company had \$259 million in cash and temporary cash investments at the end of 1986, compared with \$384 million at the end of 1985. At the end of 1986, the Company had available, for short-term borrowings, unused bank lines of credit of about \$225 million.

The Company can raise external capital by issuing first mortgage bonds or preferred stock — provided certain earnings tests are met. Tests applying to the issuance of additional first mortgage bonds and preferred stock are specified in the mortgage indenture and the Company's Restated Articles of Incorporation, respectively. As of December 31, 1986, these tests did not restrict the Company's ability to issue additional first mortgage bonds or preferred stock in amounts adequate for currently projected future funding requirements. The Company currently has no plans to issue additional first mortgage bonds or preferred stock.

The Effects of the New Tax Law are Mixed

The Tax Reform Act of 1986 is not expected to have a pronounced short-term effect on the Company. The Company's regulated businesses are generally protected under the Act from rapid shifts in either earnings or revenue requirements due to any potential reductions in existing deferred income tax balances. It is expected that tax

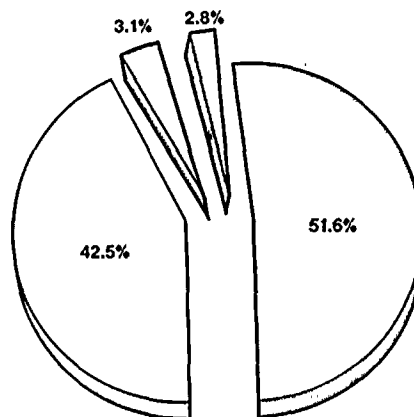
rate reductions, over time, will increase the earnings of non-utility business units and will reduce the cost of service to our utility customers through a corresponding lowering of future revenue requirements.

While the Tax Reform Act of 1986 reduces the corporate federal income tax rate from 46 percent to 34 percent, effective July 1, 1987, several other provisions, including the repeal of the investment tax credit on new construction, less favorable depreciation rates, the enactment of the corporate alternative minimum tax, and the taxing of revenues for utility services rendered but not yet billed, will have a somewhat negative impact on the Company's cash flow.

Capital Structure on December 31, 1986

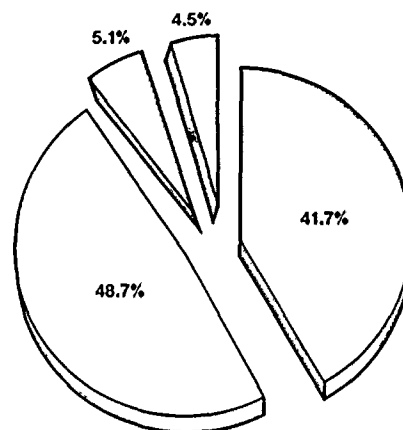
As a result of the retirement of first mortgage bonds and cumulative preferred stock discussed above, the Company's capital structure on December 31, 1986 consisted of:

1986 Capital Structure



compared with 1985:

1985 Capital Structure



- Long-term Debt, Less Current Maturities
- Preferred Stock With Mandatory Redemption Requirements
- Preferred Stock Without Mandatory Redemption Requirements
- Common Stock Equity

Results of Operations

Net earnings applicable to common stock during the last three years are:

1986	1985	1984
\$133 million or \$3.29 per share	\$122 million or \$3.30 per share	\$109 million or \$3.11 per share

The 1986 and 1985 earnings reflect the operation of the gas utility assets acquired in January 1985. The following discussion highlights significant items which affected the amount of reported earnings.

Electric Revenues Increased \$35 million; Gas Revenues Decreased \$29 million

Electric operating revenues increased \$35.0 million in 1986 over 1985 primarily because of a 3.9 percent increase in energy sales to retail residential, commercial, and industrial customers. Revenues from wholesale customers increased \$11.0 million in 1986 primarily as a result of increased revenues from San Diego Gas and Electric Company for the increased capacity made available to it by the Company. However, energy sales to firm and contingent wholesale customers declined 24.8 percent from 1985 as a result of lower-cost energy available to these utilities mainly from oil- and gas-fired power plants.

The decrease in electric operating revenues in 1985 was caused by decreased sales to wholesale customers, resulting from a reduction in contractual energy demands of four non-affiliated utilities during 1985.

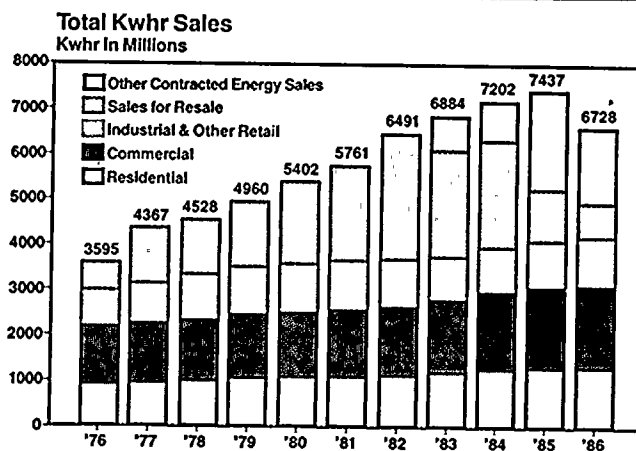
Gas operating revenues declined \$29.1 million in 1986 although only eleven months of gas operations were included in 1985 results. The primary reasons for this decline are lower gas purchase costs which are recovered through a purchased gas adjustment clause and a decrease in volumes purchased by industrial customers. However, the net gas revenues (gas revenues less gas purchased for resale) are up by \$7.9 million over 1985. The decreased consumption by industrial customers was due partially to a NMPSC order which requires New Mexico gas utilities to offer gas carriage service to qualifying customers at set rates on an available capacity basis.

Fuel and Purchased Power Expense Increased Slightly in 1986

Fuel and purchased power expense, which is partially offset by off-system energy sales to other utilities, increased \$3.9 million in 1986 after having declined \$49.5 million in 1985. The 1986 increase is due to a soft off-system energy sales market, a result of inexpensive oil and gas generation availability. The 1985 decrease was due to a 200 MW block energy sale which extends through 1989, significantly offsetting fuel and purchased power expenses.

Other Operation Expenses Increased—Largely the Result of Lease Payments

Other operation expenses increased \$69.5 million in 1986 due primarily to the incurrence of lease payments of \$39.6 million for Palo Verde Units 1 and 2 and operation expenses of \$9.9 million incurred for these units which began commercial operation in 1986. Other



operation expenses for 1985 increased \$53.8 million over 1984 primarily as a result of the addition of gas operations in January 1985 which accounted for \$41.5 million of the increase. The remainder of this increase was due primarily to lease payments for an electric transmission facility leased in 1985.

Operating Income Taxes Decreased in 1986

Operating income taxes decreased \$28.6 million in 1986 due primarily to the flow-through of tax benefits such as those associated with start-up activities at Palo Verde, losses on hedging transactions, and premiums incurred in the retirement of \$212.2 million of the Company's first mortgage bonds. These tax benefits, primarily accounted for by the flow-through method in accordance with regulatory orders of the NMPSC, provided net earnings of \$41.6 million (or \$1.03 per share), and are not expected to recur at the same high level in future years. A \$10.5 million decrease in operating income tax expense in 1985 resulted primarily from tax benefits related to start-up activities at Palo Verde.

Equity in Earnings of Unconsolidated Affiliates Showed a Loss in 1986

The results of operations from unconsolidated affiliates showed a loss in 1986 mainly due to a write-off of a venture capital investment of \$6.0 million. In addition, earnings from real estate operations declined as a result of depressed market conditions in Texas and Oklahoma.

Other Income Increased in 1986

Other income increased \$10.1 million in 1986 over 1985 principally as a result of increased interest income from the investment of proceeds from the sale and leasebacks of the Company's interest in Palo Verde Units 1 and 2. In 1985, other income declined \$14.8 million largely as the result of operating costs associated with commercial operation of a medium-density fiberboard manufacturing plant by a subsidiary of the Company. The losses experienced by the fiberboard plant continued in 1986.

Interest Charges and Preferred Dividend Requirements Decreased in 1986 as a Result of Retirements

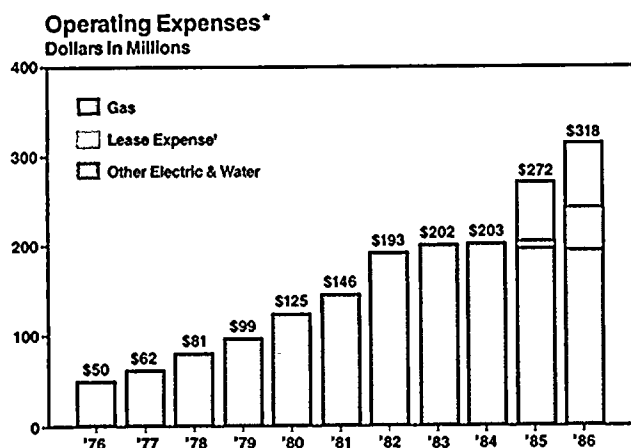
Proceeds from the sale and leasebacks of the Company's interest in Palo Verde Units 1 and 2 allowed the Company to retire \$212.2 million of first mortgage bonds and \$89.8 million of preferred stock in 1986. As a result, interest charges and preferred dividend requirements decreased \$24.0 million and \$5.7 million, respectively, from 1985. Interest on long-term debt increased \$13.5 million in 1985 largely as a result of the issuance of notes for the gas property acquisition in 1985.

The Company's Response to Marketing and Regulatory Challenges

The Governor of New Mexico has recently announced an initiative by the Company relating to a potential restructuring. The restructuring would include steps in addition to the holding company formation previously proposed. The additional steps may entail separation of the Company's electric utility operations into generation and distribution entities. Under this arrangement, the generation entity would be committed to supply the projected power needs of the distribution entity under a long-term contract. The gas and water utilities could also be separated into new entities. The Company anticipates that these additional restructuring steps, if ultimately implemented, could result in a retail electric rate reduction. We are presently discussing restructuring proposals with New Mexico state officials and other interested parties.

Uncommitted Capacity is of Concern from a Marketing and Earnings Perspective

The initiative is intended to respond generally to competitive pressures experienced by the Company in the marketing of power, and more specifically to a number of problems facing the Company. One of the Company's major concerns results from the fact that its existing and projected load requirements are substantially lower than those predicted at the time commitments were made to construct new generating units. The Company, therefore, now has substantial generation capacity in excess of its requirements for its firm customers (uncommitted capacity). The Inventory of Capacity ratemaking methodology, first implemented in 1982, was a regulatory attempt to address this situation.



*Exclusive of fuel and purchased power and gas purchased for resale expenses.

†Operating lease expenses incurred for Palo Verde Units and EIP transmission line.

Allowance for Funds Used During Construction Decreased

AFUDC, a non-cash item, decreased \$32.0 million in 1986 as a result of lower average construction work in progress balances resulting largely from the commercial operation of Palo Verde Units 1 and 2 in 1986.

Deferred Carrying Costs on Uncommitted Electric Generating Capacity Increased

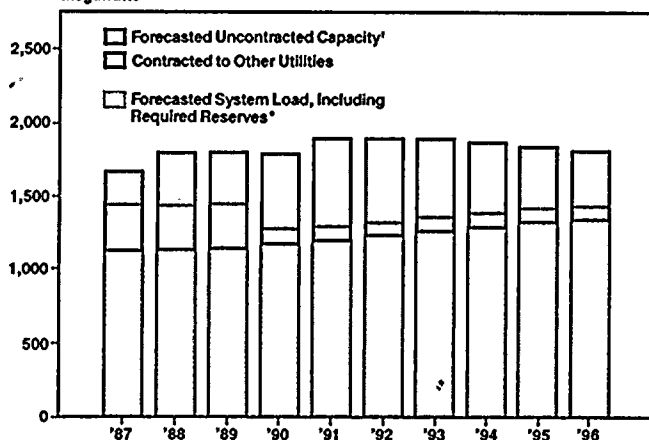
Since 1982, the Company has deferred carrying costs associated with specifically identified uncommitted generating capacity in accordance with a NMPSC order. This non-cash deferral increased \$13.0 million in 1986 over 1985 due primarily to an increase in uncommitted generating capacity resulting from the commercial operation of Palo Verde Units 1 and 2.

As of December 31, 1986, we had 1,565 megawatts of owned and leased generating capacity plus 113 megawatts being purchased from other owners of San Juan Unit 4. An additional 130 megawatts will be added following the date Palo Verde Unit 3 is placed in service (currently scheduled for the third quarter of 1987). The Company estimates that it will have 552 megawatts of uncommitted capacity available to be sold at the time of its summer peak of 1987, increasing to 705 megawatts in 1991.

Over the next five years, 36 percent of the energy associated with uncommitted capacity is contracted for sale to other utilities. However, our ability to sell the remaining uncommitted capacity or energy will be affected by transmission availability and levels of competition in the off-system market. Competition in the off-system market has intensified due, in part, to the availability of excess capacity from other utilities, a decrease in oil and natural gas prices, and the emergence of co-generation and self-generation as competing energy sources.

Projected levels of uncommitted capacity will make the Company dependent on the inventorying methodology for a substantial portion of its future earnings. We project that the inventorying methodology would defer approximately \$248 million of net carrying charges over the next five years. Earnings attributable to the inventorying methodology amounted to 10.7 percent of our 1986 net earnings.

Electric Resources: Contracted and Uncontracted
(Capacity at Time of Peak)
Megawatts



*PNM has the opportunity to recover costs of forecasted uncontracted capacity through competitive market sales revenues.

*Capacity and reserves necessary to meet the needs of both New Mexico retail customers and firm wholesale customers.

Focus on Inventorying Methodology and Palo Verde Costs

Future earnings may be adversely affected by various developments relating to the inventorying methodology. Initiatives by the Financial Accounting Standards Board (FASB) regarding phase-in plans may adversely affect the viability of the inventorying methodology. In addition, the NMPSC has scheduled a proceeding to obtain proposals for alternatives to the inventorying methodology. See note (1) to the consolidated financial statements.

Additionally, the NMPSC has initiated an investigation of Palo Verde project management and construction costs. The investigation's purpose is to determine the prudence of the Company's incurred Palo Verde costs and to quantify the costs resulting from imprudence, if any. An accounting standard recently adopted by the FASB would require the Company to charge disallowed costs, if any, to expense at the time such disallowance is determined to be probable. See notes (1) and (11) to the consolidated financial statements.

Our Natural Gas Business Also Faces Challenges

NMPSC regulations currently limit our ability to compete effectively with alternative carriers and to manage our supply requirements under changing market conditions. We have filed an application with the NMPSC seeking modifications of those regulations.

Summary: The Company is Evaluating Alternatives

The Company has considered various responses to the above issues. The likelihood of our long-term dependence on the inventorying methodology for a substantial portion of the Company's earnings, assuming the methodology continues, and uncertainties as to the continuation of the methodology, have caused us to evaluate alternatives. The prospect of lengthy adversarial proceedings concerning the prudence of Palo Verde costs, pressure on the Company within the State of New Mexico to reduce and stabilize retail rates, and intensified competition in the marketing of power, have likewise caused the examination of alternatives. The result of this examination to date has been the Company's initiative relating to the potential separation of the electric generation and distribution assets into distinct entities. Details of any additional restructuring, including the legal form of the potential new entities, are currently under consideration.

Assuming separation into a NMPSC-regulated distribution entity and a FERC-regulated generation entity, the Company anticipates that the inventorying methodology may no longer be appropriate. Also, the review by the NMPSC of the prudence of Palo Verde costs would be obviated since the Company's interest in Palo Verde would then be a part of the FERC-regulated generation entity. Implementation of any such restructuring will be subject to numerous conditions, including required regulatory and other approvals.

Selected Financial Data

	1986	1985	1984	1983	1982
(In thousands except per share amounts and ratios)					
Total Operating Revenues	\$ 697,995	\$ 689,982	\$ 445,328	\$ 397,474	\$ 426,543
Net Earnings	\$ 151,005	\$ 146,310	\$ 132,840	\$ 140,519	\$ 115,822
Earnings per Common Share	\$ 3.29	\$ 3.30	\$ 3.11	\$ 3.53	\$ 3.22
Total Assets	\$2,756,144	\$3,010,238	\$2,598,744	\$2,486,429	\$2,145,984
Preferred Stock with Mandatory Redemption Requirements	\$ 66,147	\$ 119,080	\$ 121,080	\$ 123,700	\$ 125,000
Long-Term Debt, less Current Maturities	\$ 901,511	\$1,143,355	\$1,030,557	\$ 974,290	\$ 811,653
Common Stock Data:					
Dividends paid per common share	\$ 2.92	\$ 2.89	\$ 2.85	\$ 2.81	\$ 2.77
Dividend pay-out ratio	88.8%	87.6%	91.7%	79.6%	86.0%
Market price per common share at year end	\$ 33.000	\$ 29.500	\$ 24.375	\$ 25.375	\$ 26.000
Book value per common share at year end	\$ 26.51	\$ 25.73	\$ 25.28	\$ 25.20	\$ 24.35
Average number of common shares outstanding	40,401	37,059	35,011	32,956	28,508
Return on average common equity	12.8%	13.2%	12.5%	14.3%	13.6%
Ratio of Earnings to Fixed Charges (S.E.C. Method)	2.51	2.63	2.32	2.81	2.70
Capitalization:					
Common stock equity	51.6%	41.7%	42.1%	41.5%	42.8%
Preferred stock:					
Without mandatory redemption requirements	2.8	4.5	4.9	5.2	5.8
With mandatory redemption requirements	3.1	5.1	5.5	6.0	6.9
Long-term debt, less current maturities	42.5	48.7	47.5	47.3	44.5
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

The selected financial data should be read in conjunction with the consolidated financial statements and notes to consolidated financial statements contained elsewhere in this report.

Management's Responsibility for Financial Statements

The management of Public Service Company of New Mexico is responsible for the preparation and presentation of the accompanying consolidated financial statements. The consolidated financial statements have been prepared in conformity with generally accepted accounting principles and include amounts that are based on informed estimates and judgements of management.

Management maintains a system of internal accounting controls which it believes is adequate to provide reasonable assurance that assets are safeguarded, transactions are executed in accordance with management authorization and the financial records are reliable for preparing the consolidated financial statements. The system of internal accounting controls is supported by written policies and procedures, a staff of internal auditors who conduct comprehensive internal audits and by the selection and training of qualified personnel.

The Board of Directors, through its Audit Committee comprised entirely of outside directors, meets periodically with management, internal auditors and the Company's independent auditors to discuss auditing, internal control and financial reporting matters. To ensure their independence, both the internal auditors and independent auditors have full and free access to the Audit Committee.

The independent auditors, Peat, Marwick, Mitchell & Co., are engaged to examine the Company's consolidated financial statements in accordance with generally accepted auditing standards.

Auditors' Report

The Board of Directors and Stockholders
Public Service Company of New Mexico:

We have examined the consolidated balance sheet of Public Service Company of New Mexico and subsidiaries as of December 31, 1986 and 1985 and the related consolidated statements of earnings, retained earnings and changes in financial position 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 aforementioned consolidated financial statements present fairly the financial position of Public Service Company of New Mexico and subsidiaries at December 31, 1986 and 1985 and the results of their operations and changes in their financial position 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.

Albuquerque, New Mexico
February 19, 1987

Consolidated Statement of Earnings

	Year Ended December 31		
	1986	1985	1984
	(In thousands except per share amounts)		
Operating Revenues:			
Electric	\$ 443,084	\$ 408,101	\$438,974
Gas (note 10)	244,666	273,737	—
Water	10,245	8,144	6,354
Total operating revenues	<u>697,995</u>	<u>689,982</u>	<u>445,328</u>
Operating Expenses:			
Fuel and purchased power	50,318	46,456	95,904
Gas purchased for resale	149,685	186,691	—
Other operation expenses	191,604	122,085	68,278
Maintenance and repairs	41,879	42,691	34,075
Depreciation and amortization	60,249	55,366	48,975
Taxes, other than income taxes	30,511	29,729	19,246
Income taxes (note 5)	(6,727)	21,850	32,356
Total operating expenses	<u>517,519</u>	<u>504,868</u>	<u>298,834</u>
Operating income	<u>180,476</u>	<u>185,114</u>	<u>146,494</u>
Other Income and Deductions, net of taxes (note 5):			
Allowance for equity funds used during construction	34,926	57,848	50,735
Deferred carrying costs on uncommitted electric generating capacity	16,191	3,230	2,924
Equity in earnings (loss) of unconsolidated affiliates	(1,567)	5,815	7,975
Other	4,193	(5,889)	8,865
Net other income and deductions	<u>53,743</u>	<u>61,004</u>	<u>70,499</u>
Income before interest charges	<u>234,219</u>	<u>246,118</u>	<u>216,993</u>
Interest Charges:			
Interest on long-term debt	87,961	111,974	98,463
Other interest charges	9,147	10,779	8,421
Allowance for borrowed funds used during construction	(13,894)	(22,945)	(22,731)
Net interest charges	<u>83,214</u>	<u>99,808</u>	<u>84,153</u>
Net Earnings	<u>151,005</u>	<u>146,310</u>	<u>132,840</u>
Preferred Stock Dividend Requirements	<u>18,187</u>	<u>23,901</u>	<u>23,990</u>
Net Earnings Applicable to Common Stock	<u>\$ 132,818</u>	<u>\$ 122,409</u>	<u>\$108,850</u>
Average Number of Common Shares Outstanding	<u>40,401</u>	<u>37,059</u>	<u>35,011</u>
Earnings per Share of Common Stock	<u>\$ 3.29</u>	<u>\$ 3.30</u>	<u>\$ 3.11</u>
Dividends Paid per Share of Common Stock	<u>\$ 2.92</u>	<u>\$ 2.89</u>	<u>\$ 2.85</u>

Consolidated Statement of Retained Earnings

	Year Ended December 31		
	1986	1985	1984
	(In thousands)		
Balance at Beginning of Year	\$ 198,703	\$ 182,964	\$173,420
Net Earnings	151,005	146,310	132,840
Dividends:			
Cumulative preferred stock	(18,187)	(23,901)	(23,990)
Common stock	(118,105)	(106,670)	(99,306)
Balance at End of Year	<u>\$ 213,416</u>	<u>\$ 198,703</u>	<u>\$182,964</u>

See accompanying notes to consolidated financial statements.

Consolidated Balance Sheet**December 31**
1986 1985**Assets**

(In thousands)

Utility Plant, at Original Cost (notes 3, 7 and 11):

Electric plant in service	\$1,499,548	\$1,442,532
Gas plant in service	327,188	311,049
Water plant in service	38,834	36,155
Common plant in service	44,820	41,622

Less accumulated depreciation and amortization

Construction work in progress

Plant held for future use

Nuclear fuel, net of accumulated amortization

Net utility plant

Other Property and Investments:

Non-utility property, at cost, net of accumulated depreciation, partially pledged

Investment in unconsolidated affiliates

Other, at cost

Total other property and investments

Current Assets:

Cash

Temporary cash investments

Receivables, net

Fuel, materials and supplies, at average cost

Gas in underground storage, at last-in, first-out cost

Prepaid expenses

Total current assets

Deferred Charges**Capitalization and Liabilities****Capitalization:**

Common stock equity (note 2):

Common stock outstanding—41,313,358 shares in 1986 and 37,965,868 shares in 1985

Additional paid-in capital

Retained earnings

Total common stock equity

Cumulative preferred stock without mandatory redemption requirements (note 2)

Cumulative preferred stock with mandatory redemption requirements (note 2)

Long-term debt, less current maturities (note 3)

Total capitalization

Current Liabilities:

Short-term debt (note 4)

Accounts payable

Current maturities of long-term debt (note 3)

Accrued interest and taxes

Other current liabilities

Total current liabilities

Deferred Credits:

Accumulated deferred investment tax credits (note 5)

Accumulated deferred income taxes (note 5)

Other deferred credits

Total deferred credits

Commitments, Contingencies and Subsequent Event (notes 7, 8, 9, 11 and 13)**\$2,756,144 \$3,010,238**

See accompanying notes to consolidated financial statements.

Consolidated Statement of Changes in Financial Position

	Year Ended December 31		
	1986	1985	1984
	(In thousands)		
Funds Generated Internally:			
Net earnings	\$ 151,005	\$ 146,310	\$132,840
Charges (credits) to earnings not requiring funds:			
Depreciation and amortization	78,432	64,068	52,844
Provision for non-current deferred income taxes, net	3,279	5,614	27,175
Investment tax credits, net	38,432	44,651	17,306
Allowance for equity funds used during construction	(34,926)	(57,848)	(50,735)
Deferred carrying costs on uncommitted electric generating capacity	(16,191)	(3,230)	(2,924)
Earnings of unconsolidated affiliates	3,121	(11,545)	(14,153)
Funds derived from operations	223,152	188,020	162,353
Less cash dividends	136,292	130,571	123,296
Total funds generated internally	<u>86,860</u>	<u>57,449</u>	<u>39,057</u>
Funds Obtained from (Applied to) Outside Sources:			
Sale of common stock	103,676	47,975	48,123
Sale of first mortgage bonds	—	—	65,000
Proceeds from pollution control revenue bonds	4,037	52,146	14,583
Reacquisition of preferred stock	(89,825)	—	—
Reacquisition of first mortgage bonds	(212,247)	—	—
Bond and preferred stock reacquisition premiums	(44,781)	—	—
Loss on hedging transactions	(17,597)	—	—
Increases in other long-term debt	141,529	145,696	31,377
Decreases in other long-term debt	(175,948)	(84,129)	(54,266)
Increase (decrease) in short-term debt, net	(16,813)	19,122	(95,977)
Proceeds from sale of utility plant, net	429,612	363,421	—
Decrease (increase) in working capital, other than short-term debt	11,522	(169,983)	214,443
Other	12,425	119	2,091
Total funds obtained from outside sources	<u>145,590</u>	<u>374,367</u>	<u>225,374</u>
Total funds generated	<u>\$ 232,450</u>	<u>\$ 431,816</u>	<u>\$264,431</u>
Construction Expenditures, Investments and Acquisition:			
Utility plant additions	\$ 163,489	\$ 203,347	\$224,599
Increase in other property and investments	68,961	15,227	39,832
Acquisition of non-current New Mexico gas properties:			
Property, plant and equipment	—	225,719	—
Other assets	—	5,329	—
Deferred credits	—	(17,806)	—
Total construction expenditures, investments and acquisition	<u>\$ 232,450</u>	<u>\$ 431,816</u>	<u>\$264,431</u>

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

December 31, 1986, 1985 and 1984

(1) Summary of Significant Accounting Policies

System of Accounts

The Company maintains its accounts for utility operations primarily in accordance with the uniform systems of accounts prescribed by the Federal Energy Regulatory Commission (FERC) and the National Association of Regulatory Utility Commissioners (NARUC), and adopted by the New Mexico Public Service Commission (NMPSC). As a result of the ratemaking process, the application of generally accepted accounting principles by the Company differs in certain respects from the application by non-regulated businesses. Such differences generally regard the time at which certain items enter into the determination of net earnings in order to follow the principle of matching costs and revenues.

Certain prior year amounts have been reclassified for comparability. The gas gathering subsidiary is classified as non-utility in the accompanying consolidated financial statements. All prior periods included in this report have been reclassified accordingly.

Principles of Consolidation

The consolidated financial statements include the accounts of Public Service Company of New Mexico and subsidiaries over which it exercises control. All significant intercompany transactions and balances have been eliminated. Investments in unconsolidated affiliates are accounted for by the equity method.

Utility Plant

Utility plant is stated at original cost, which includes payroll-related costs such as taxes, pension and other fringe benefits, administrative costs and an allowance for funds used during construction.

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

Depreciation and Amortization

Provision for depreciation of utility plant is made at annual straight-line rates approved by the NMPSC. The average depreciation rates used are as follows:

	1986	1985	1984
Electric plant	3.23%	3.26%	3.29%
Gas plant	3.17%	3.00%	—
Water plant	2.03%	2.09%	2.04%
Common plant	9.46%	9.38%	7.28%

The provision for depreciation of certain equipment, including amortization applicable to capital leases, is charged to clearing accounts

and subsequently allocated to operating expenses or construction projects based on the use of the equipment.

Depreciation of non-utility property is computed on the straight-line method.

Amortization of nuclear fuel is computed based on the units of production method.

Allowance for Funds Used During Construction (AFUDC)

As provided by the uniform systems of accounts, AFUDC, a non-cash item, is charged to utility plant. AFUDC represents the cost of borrowed funds (allowance for borrowed funds used during construction) and a return on other funds (allowance for equity funds used during construction). The Company capitalizes AFUDC on construction work in progress (CWIP) to the extent allowed by regulatory agencies. The Company also capitalizes AFUDC on its plant held for future use as allowed by the NMPSC.

AFUDC is computed using the maximum rate, net of taxes, permitted by FERC. The rates used were 8.97 percent, 9.22 percent and 9.34 percent for 1986, 1985 and 1984, respectively, compounded semi-annually.

Deferred Carrying Costs on Uncommitted Electric Generating Capacity

Effective in 1982, the Company received approval of the NMPSC to implement an electric utility ratemaking methodology called Inventory of Capacity. Under this methodology, the Company records as income and as a deferred charge an amount equivalent to carrying charges associated with specifically identified uncommitted generating capacity. When off-system energy sales are made from such capacity, the net proceeds are deducted from the deferred carrying charges. The net deferrals each year are limited to a specified percentage of the cost of uncommitted generating capacity. Under existing orders of the NMPSC, all charges remaining after off-system energy sale credits will be recovered over the useful life of the generating facility when the uncommitted capacity is used to meet NMPSC jurisdictional load.

Through 1986, deferred carrying charges have totaled \$76.6 million, of which \$40.0 million has been recovered from off-system energy sales, \$4.0 million has been recovered in rates charged to retail customers and \$7.6 million was recovered through the sales of portions of San Juan Unit 4, leaving \$25.0 million in deferred charges to be recovered over the useful life of the generating facilities.

A potential change in financial accounting standards and reevaluation by the NMPSC in 1988 will cause the above-described methodology to be reconsidered. A potential restructuring being studied by the Company may cause such methodology to be inappropriate. See note (13).

Financial Accounting Standards for Regulated Enterprises

In December 1985, the Financial Accounting Standards Board (FASB) proposed an amendment to Statement of Financial Accounting Standards (SFAS) No. 71, Accounting for the Effects of Certain Types of Regulation. A portion of the amendment relating to accounting for phase-in plans (such as the Inventory of Capacity ratemaking

methodology), if approved as proposed, would have required the Company to obtain NMPSC approval for significant revisions to the Inventory of Capacity ratemaking methodology. If such revisions were not approved by the NMPSC, the Company would have been required to write off amounts previously deferred under the Inventory of Capacity ratemaking methodology and would have restated the financial statements for prior years, reducing net earnings for 1982 through 1986 by a total of up to \$25.0 million. In addition, the Company's financial statements for future years would reflect charges to expense for those costs yet to be incurred that would otherwise have been deferred under the existing methodology. The proposed amendment also provided for changes in the accounting for costs disallowed by regulators and for abandoned plants. Following a public comment period and hearings, the FASB indicated its intention to issue a new exposure draft of its proposed amendment relating to the accounting for phase-in plans, rather than to issue the amendment as originally proposed. The amounts, if any, which the Company will be required to charge to expense in the future will not be determinable until a final amendment is issued by the FASB and then considered by the Company and the NMPSC.

In December 1986, the FASB issued SFAS No. 90 which amends SFAS No. 71 and requires that any disallowed costs be charged to expense at the time such disallowance is determined to be probable. SFAS No. 90 also provides that if the cost of an abandoned plant exceeds the present value of future revenues expected to be provided to recover the cost of the abandoned plant, a loss shall be recorded in the amount of such excess. The Company currently has no such costs disallowed by the NMPSC, which would be impacted by SFAS No. 90. See note (11).

Fuel, Purchased Power and Gas Purchase Costs

Economy and other near-term energy transactions are shown as a reduction of fuel and purchased power expenses. The Company uses the deferral method of accounting for the portion of fuel, purchased power and gas purchase costs which are reflected in subsequent periods under fuel and purchased gas adjustment clauses. Future recovery of these costs is based on orders issued by the regulatory commissions.

Amortization of Debt Discount, Premium and Expense

Discount, premium and expense related to the issuance and retirement of long-term debt are amortized over the lives of the respective issues.

Income Taxes

Certain revenue and expense items in the Consolidated Statement of Earnings are recorded for financial reporting purposes in a year different from the year in which they are recorded for income tax purposes. Deferred income taxes are provided on these timing differences to the extent allowed for ratemaking purposes. This

method, known as tax normalization, is used primarily for differences attributable to deferred fuel costs, the use of liberalized depreciation and accelerated cost recovery methods, pension costs and receipt of advance lease payments. Certain other timing differences result in reductions of income tax expense in the current year as required by the NMPSC. This flow-through method is used for minor differences between book and tax depreciation, certain capitalized construction costs including start-up costs at Palo Verde Nuclear Generating Station (PVNGS), premiums on retirement of first mortgage bonds, losses on hedging transactions and for pollution control facilities which are amortized over five years for tax purposes.

Rates subject to FERC jurisdiction allow recovery of amounts necessary to provide additional tax normalization of the timing differences described above which are accounted for under the flow-through method for other customers. Provision has been made for additional deferred income taxes attributable to amounts collected under these rates.

Deferred taxes are provided on all non-permanent differences between book and taxable income attributable to non-utility operations. These differences consist primarily of interest and other expenses which are capitalized for book purposes and income which is taxable in periods other than when recognized for financial reporting purposes.

The Company defers investment tax credits related to utility assets and amortizes them over the estimated useful lives of the related assets. Investment tax credits generated by non-utility properties are recognized as reductions of current income tax expense.

Revenues

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

(2) Common Stock and Cumulative Preferred Stock

The number of authorized shares of common stock with par value of \$5 per share is 80,000,000 shares. The Board of Directors has periodically reserved common stock for the Shareholder's Dividend Reinvestment Plan, the Employee Stock Purchase Plan, the Master Employee Savings Plans and the Consumer Stock Plan (Stock Plans), with 2,637,801 shares remaining unissued at December 31, 1986. However, it is anticipated that shares for Stock Plans (except the Consumer Stock Plan) will be obtained from open-market purchases after April 1987.

The number of authorized shares of cumulative preferred stock is 10,000,000 shares. Information concerning the cumulative preferred stock at December 31, 1986 is shown on the following page:

	Stated Value	Shares Outstanding	Stated Redemption Price	Aggregate Stated Value (In thousands)
Without Mandatory Redemption Requirements:				
1965 Series, 4.58%	\$100	130,000	\$102.00	\$13,000
8.48% Series	100	200,000	106.00	20,000
8.80% Series	100	260,000	106.20	26,000
		<u>590,000</u>		<u>\$59,000</u>
With Mandatory Redemption Requirements:				
8.75% Series	\$100	360,800	\$105.80	\$36,080
12.52% Series	50	700,000	—	35,000
14.75% Series	100	31,750	109.85	3,175
		<u>1,092,550</u>		<u>74,255</u>
Redeemable within One Year:				
8.75% Series	100	(26,000)	100.00	(2,600)
12.52% Series	50	(46,660)	50.00	(2,333)
14.75% Series	100	(31,750)	100.00	(3,175)
		<u>(104,410)</u>		<u>(8,108)</u>
		<u>988,140</u>		<u>\$66,147</u>

The Company, upon thirty days' notice, may redeem the cumulative preferred stock at stated redemption prices plus accrued and unpaid dividends. Redemption prices are at reduced premiums in future years. No redemptions may be made prior to October 15, 1991, except for use of sinking fund and optional redemptions, for the 12.52% Series.

Mandatory redemption requirements and planned optional redemptions for 1987 through 1991 are \$8,108,000, \$3,613,000,

\$3,633,000, \$3,633,000 and \$3,633,000, respectively.

In 1986, the Company redeemed or purchased approximately \$89.8 million of the Company's cumulative preferred stock, including the 9.16% Series, 9.2% Series, 10.12% Series and a portion of the 14.75% Series.

Changes in common stock, additional paid-in capital and cumulative preferred stock are as follows:

	Common Stock		Additional Paid-In Capital	Cumulative Preferred Stock			
				Without Mandatory Redemption Requirements		With Mandatory Redemption Requirements	
	Number of Shares	Aggregate Par Value		Number of Shares	Aggregate Stated Value	Number of Shares	Aggregate Stated Value
(Dollars in thousands)							
Balance at December 31, 1983	33,932,809	\$169,664	\$511,975	1,660,000	\$106,000	1,587,000	\$123,700
Stock Plans	2,194,380	10,972	37,151	—	—	—	—
Redemption of stock	—	—	507	—	—	(26,200)	(2,620)
Balance at December 31, 1984	36,127,189	180,636	549,633	1,660,000	106,000	1,560,800	121,080
Stock Plans	1,838,679	9,193	38,782	—	—	—	—
Redeemable within one year	—	—	—	—	—	(20,000)	(2,000)
Balance at December 31, 1985	37,965,868	189,829	588,415	1,660,000	106,000	1,540,800	119,080
Public issue of stock	1,800,000	9,000	44,256	—	—	—	—
Stock Plans	1,547,490	7,738	42,682	—	—	—	—
Redemption of stock	—	—	—	(1,070,000)	(47,000)	(448,250)	(44,825)
Redeemable within one year	—	—	—	—	—	(104,410)	(8,108)
Balance at December 31, 1986	<u>41,313,358</u>	<u>\$206,567</u>	<u>\$675,353</u>	<u>590,000</u>	<u>\$ 59,000</u>	<u>988,140</u>	<u>\$ 66,147</u>

Charter provisions relating to the cumulative preferred stock and the indenture securing the first mortgage bonds impose certain restrictions upon the payment of cash dividends on common stock

of the Company. At December 31, 1986, there were no retained earnings restricted under such provisions.

(3) Long-Term Debt

The details of the Company's outstanding long-term debt are as follows:

Issue and Final Maturity	Interest Rates	1986	1985
(In thousands)			
First Mortgage Bonds:			
1986 through 1991	4 $\frac{3}{8}$ % to 4 $\frac{7}{8}$ %	\$ 16,936	\$ 17,233
1992 through 1996	13 $\frac{1}{8}$ %	30,022	65,000
1997 through 2001	5 $\frac{7}{8}$ % to 8 $\frac{1}{8}$ %	47,565	48,294
2002 through 2006	7 $\frac{1}{2}$ % to 10 $\frac{1}{8}$ %	85,875	86,697
2007 through 2011	8 $\frac{1}{8}$ % to 17 $\frac{1}{2}$ %	89,837	151,848
2012 through 2016	12 $\frac{7}{8}$ % to 13 $\frac{1}{8}$ %	7,443	125,000
1993 through 2013—pollution control series, securing pollution control revenue bonds	5.9% to 10 $\frac{1}{4}$ %	437,045	437,045
Funds held by trustee		(5,163)	(6,593)
Total First Mortgage Bonds		709,560	924,524
Pollution Control Revenue Bonds:			
2003 through 2013	10% to 10 $\frac{1}{4}$ %	100,000	100,000
2009	variable rate	37,300	37,300
Funds Held by Trustee		(13,448)	(14,738)
Secured Notes (1986 through 1987)	8%	40,203	90,892
Other, Including Unamortized Premium and Discount		73,803	83,100
Total Long-Term Debt		947,418	1,221,078
Current Maturities		(45,907)	(77,723)
Long-Term Debt, less Current Maturities		\$901,511	\$1,143,355

In 1986, proceeds from sale and leaseback transactions of the Company's interests in PVNGS Units 1 and 2 allowed the Company to redeem or purchase approximately \$212 million of the Company's first mortgage bonds. Also, the Company converted, pursuant to mandatory conversion provisions, the \$23 million principal amount of 1984 Series A Pollution Control Revenue Bonds, secured by first mortgage bonds, from a variable rate to a fixed rate of 7.75 percent per annum.

Substantially all utility plant is pledged to secure the first mortgage bonds. A portion of certain series of long-term debt will be redeemed serially prior to their due dates. The aggregate amounts (in thousands) of maturities through 1991 on long-term debt outstanding at December 31, 1986, are as follows:

1987	\$45,907
1988	\$41,874
1989	\$15,634
1990	\$10,042
1991	\$15,576

Long-term debt includes certain issues which, although current

by their terms, can be refinanced by existing long-term credit arrangements.

(4) Short-Term Debt

The Company's interim financing requirements are met through the issuance of commercial paper and notes payable to banks which, respectively, amounted to approximately \$19.7 million and \$12.9 million at December 31, 1986, and approximately \$32.0 million and \$17.4 million at December 31, 1985. At December 31, 1986, the Company had unused credit commitments from various banks totaling approximately \$225 million. These credit arrangements are used to support the issuance of commercial paper and to provide for short-term borrowings. The Company generally pays commitment fees or maintains cash balances on deposit with banks to assure availability of its credit commitments. These commitments consist of both lines of credit and revolving credit agreements ranging in duration from one to six years.

(5) Income Taxes

Income taxes consist of the following components:

	1986	1985	1984
		(In thousands)	
Current Federal income tax	\$ 57,012	\$19,500	\$ 1,878
Current State income tax	23,869	12,633	2,519
Deferred Federal income tax	(8,985)	25,399	20,365
Deferred State income tax	(2,645)	2,804	3,966
Investment tax credit utilized and deferred	42,992	41,939	20,726
Amortization of accumulated investment tax credits	(5,176)	(3,332)	(3,060)
Total income taxes	<u>\$107,067</u>	<u>\$98,943</u>	<u>\$46,394</u>
Charged (credited) to operating expenses	\$ (6,727)	\$21,850	\$32,356
Charged to other income and deductions	113,794	77,093	14,038
Total income taxes	<u>\$107,067</u>	<u>\$98,943</u>	<u>\$46,394</u>

Deferred income taxes result from certain timing differences between the recognition of income and expense for tax and financial reporting purposes, as described in note (1).

The major sources of these differences for which deferred taxes have been provided and the tax effects of each are as follows:

	1986	1985	1984
		(In thousands)	
Deferred fuel costs	\$ (3,074)	\$ 3,504	\$ 1,251
Depreciation and cost recovery timing differences	18,800	23,822	24,000
Pension cost timing differences	(4,101)	—	—
Provision for refunds	—	2,621	(7,071)
Charitable contribution carryforward	584	(458)	2,301
Receipt of advance lease payments	(31,007)	—	—
Other	7,168	(1,286)	3,850
Total deferred taxes	<u>\$ (11,630)</u>	<u>\$28,203</u>	<u>\$24,331</u>

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

	1986	1985	1984
Federal income tax statutory rate	46.0%	46.0%	46.0%
Allowance for funds used during construction	(8.7)	(15.2)	(18.9)
Deferred carrying costs on uncommitted electric generating capacity	(2.9)	(.6)	(.8)
Premiums on retirement of first mortgage bonds	(5.7)	—	—
Losses on hedging transactions	(2.8)	—	—
PVNGS start-up costs	(4.2)	(3.5)	—
Capital gains rate net of minimum tax	(6.1)	(3.8)	(.6)
Investment tax credits	(2.0)	(1.5)	(4.1)
Reversal of flow-through items resulting from sale of PVNGS	21.4	17.5	—
Gains on the sale of PVNGS, deferred for financial reporting purposes	6.7	—	—
State income tax	4.4	3.4	2.0
Other	(4.6)	(2.0)	2.3
Company's effective tax rate	<u>41.5%</u>	<u>40.3%</u>	<u>25.9%</u>

The cumulative net amount of income tax timing differences upon which deferred income taxes have not been provided is estimated to be approximately \$66.5 million and \$51.7 million as of December 31, 1986 and 1985, respectively. Such amounts exclude AFUDC and deferred carrying costs on uncommitted electric generating capacity which are recorded on a net of tax basis.

(6) Pension Plan

The Company and its subsidiaries have a pension plan covering substantially all of their employees, including officers. The plan is non-contributory and provides for benefits to be paid to eligible employees at retirement based primarily upon years of service with the Company and their compensation rates near retirement. The Company's policy is to fund actuarially determined contributions. Contributions to the plan reflect benefits attributed to employees' years of service to date and also for services expected to be provided in the future. Plan assets primarily consist of common and preferred stocks, fixed income securities (primarily U.S. obligations) and real estate. In 1986, the Company reduced its workforce by 367 positions in a program that included early retirements, voluntary and involuntary separation packages and layoffs. The effect of this reduction is reflected in the termination loss and curtailment gain shown in the table below.

Effective January 1, 1986, the Company adopted the principles of SFAS No. 87 and 88 for net periodic pension cost calculation for 1986. The effect of the adoption of SFAS No. 87 was to reduce pension cost by approximately \$7.3 million for 1986. Prior to 1986, net periodic pension cost was based on the provisions of APB Opinion No. 8. In 1985, prior to adoption of SFAS No. 87, the Company changed its actuarial method from the Entry Age Normal Cost Method with Frozen Past Service Liability to the Projected Unit Credit Method which is now required by SFAS No. 87. The effect of such change was to reduce the contribution by approximately \$3.4 million in 1985.

The components of net periodic pension cost and total pension cost (in thousands) for 1986 include:

Service cost	\$ 4,878
Interest cost	8,668
Actual return on plan assets	(12,163)
Other	872
Net periodic pension cost	2,255
Termination loss	10,640
Curtailment gain	(2,868)
Total pension cost	<u>\$ 10,027</u>

Total pension cost, part of which was charged to utility plant, was approximately \$8.2 million in 1985 and \$5.6 million in 1984.

The following sets forth the plan's funded status and amounts recognized in the Company's Consolidated Balance Sheet at December 31, 1986 (in thousands):

Vested benefits	\$ 70,089
Non-vested benefits	<u>7,790</u>
Accumulated benefit obligation	77,879
Effect of future compensation levels	<u>48,399</u>
Projected benefit obligation	126,278
Fair value of plan assets	<u>111,774</u>
Unfunded excess of projected benefit obligations over plan assets	<u>\$ 14,504</u>

The unfunded excess consists of the following:

Net unrecognized loss from past experience different from assumed	\$ 21,931
Unamortized asset at transition, being amortized over 16 years	(17,454)
Pension liability included in the balance sheet	<u>10,027</u>
	<u>\$ 14,504</u>

The weighted average discount rate used to measure the projected benefit obligation is 8.5 percent; the weighted average discount rate used to measure the net periodic pension cost is 9.75 percent; the rate of increase in future compensation levels based on age-related scales is 6.2 percent; and the expected long-term rate of return on plan assets is 10.0 percent.

(7) Construction Program and Jointly-Owned Plants

The Company operates and jointly owns the steam turbo-electric San Juan Generating Station. At December 31, 1986, the Company owned an undivided 50 percent interest in the first three units of the San Juan Generating Station and about 55.5 percent of Unit 4.

The Company has been participating with several other utilities in the construction of three generating units at the Palo Verde Nuclear Generating Station. The first unit commenced commercial operation on January 28, 1986, and the second unit commenced commercial operation on September 19, 1986. In 1985 and 1986, the Company completed sale and leaseback transactions for its undivided interests in Units 1 and 2 and certain related common facilities. As a result, the Company received approximately \$900.5 million from these sales. At December 31, 1986, the Company owned an undivided 10.2 percent interest in Unit 3, which is expected to be completed in the third quarter of 1987.

The Company also has undivided interests in transmission facilities which are not significant.

It is estimated that the Company's utility construction expenditures for 1987 will approximate \$140 million, including expenditures on the jointly-owned projects. In connection therewith, substantial commitments have been made.

At December 31, 1986, the Company's ownership interest and investments in jointly-owned generating facilities are:

Station (Fuel Type)	Plant In Service	Accumulated Depreciation	Construction Work in Progress	Composite Ownership Interest
(In thousands)				
San Juan Generating Station (Coal)	\$794,137	\$163,885	\$ 10,476	51.6%
Palo Verde Nuclear Generating Station Unit 3 (Nuclear)*	\$ 5,973	\$ 91	\$269,936	10.2%
Four Corners Generating Station Units 4 and 5 (Coal)	\$ 89,123	\$ 15,051	\$ 10,642	13.0%

*Includes the Company's remaining interest in common facilities for all PVNGS units.

(8) Long-Term Power Purchase Contracts

The Company has entered into contracts for the purchase of electric power. Under one of these contracts, which expires in 1995, the Company is obligated to pay certain minimum amounts and a variable component representing the expenses associated with the energy purchased and debt service costs associated with capital improvements. Total obligations under this contract during 1986 amounted to \$39.2 million. The minimum payment for each of the next five years under this contract is approximately \$28.0 million annually.

(9) Lease Commitments

The Company classifies its leases in accordance with generally accepted accounting principles. The Company leases certain nuclear generating facilities, transmission facilities, office buildings and other equipment under operating leases. In 1985 and 1986, the Company completed sale and leaseback transactions for its undivided interests in PVNGS Units 1 and 2 and certain related common facilities. The aggregate semi-annual lease payments for these leases are approximately \$42.3 million over a base lease term of approximately 29 years. Each PVNGS lease contains renewal and fair market value purchase options at the end of the base lease term. Total net leased property under capital leases at December 31, 1986 and 1985 was approximately \$5.4 million and \$7.1 million, respectively.

Future minimum lease payments at December 31, 1986 are:

	Capital Leases	Operating Leases
(In thousands)		
1987	\$ 3,618	\$ 98,695
1988	3,310	98,048
1989	2,951	97,458
1990	1,096	96,972
1991	20	96,706
Later years	27	2,168,642
Total minimum lease payments	11,022	<u>\$2,656,521</u>
Less amount representing interest and executory costs	<u>2,551</u>	
Present value of net minimum lease payments	<u>\$ 8,471</u>	

Operating lease expense was \$59,104,000 in 1986, \$15,312,000 in 1985 and \$6,047,000 in 1984. As of December 31, 1986, the aggregate minimum payments to be received in future periods under non-cancelable subleases are approximately \$4,057,000.

(10) Gas Utility Asset Acquisition

On January 28, 1985, the Company acquired the New Mexico natural gas utility assets of Southern Union Company. The acquisition was in connection with the settlement of antitrust litigation brought against Southern Union by the Company and others. The assets were purchased for net book value, net of liabilities assumed, which was approximately \$208.4 million, less \$51.5 million, representing the amount of the settlement to all plaintiffs.

The acquisition was accounted for as a purchase and, accordingly, the Company's financial statements reflect the assets, liabilities and operating results from the acquisition date forward.

The following unaudited pro forma information shows the results of operations for the years ended December 31, 1985 and 1984 as though the acquisition had occurred at the beginning of each period presented (in thousands except per share amounts):

	Year Ended December 31	
	1985	1984
Operating revenues	\$728,607	\$795,500
Net earnings	\$149,281	\$142,705
Earnings per share of common stock	\$3.38	\$3.39

(11) Palo Verde Nuclear Generating Station

As stated in note (7), the Company has been participating with other utilities in the construction of three units of PVNGS. In 1985 and 1986, the Company completed sale and leaseback transactions for its undivided interest in PVNGS Units 1 and 2. PVNGS Units 1 and 2 were declared in commercial service in 1986. Unit 3 is scheduled to achieve firm power operation in the third quarter of 1987. Under the Inventory of Capacity ratemaking methodology, PVNGS is not currently in the ratebase and is not scheduled to begin entering ratebase until the 1990s.

During 1984, the NMPSC along with other state regulatory commis-

sions initiated an independent audit of PVNGS project management and construction costs. Legal challenges were made by the Company and another participant, and a third participant and its commission reached a settlement on its share of PVNGS costs. Subsequently, the four state audit was terminated in September 1986. On January 14, 1987, the NMPSC issued an order docketing a case to investigate the prudence of the Company's share of the PVNGS costs. A hearing on this matter has been scheduled for February 1988. Management is unable to predict what findings the NMPSC will make as a result of that hearing. Management believes that PVNGS was managed and constructed in a prudent manner and that any review by the NMPSC will not prevent the Company from recovering its investment. See note (13).

The Federal Price-Anderson Act currently limits the public liability for claims that could arise from a nuclear incident to a maximum amount of \$700 million, as of February 10, 1987, for each nuclear reactor licensed for operation by the Nuclear Regulatory Commission (NRC). The PVNGS participants have purchased primary insurance for this exposure in the maximum available amount, presently \$160 million, with the remaining \$540 million being provided by secondary financial protection as required by the Price-Anderson Act

and the NRC. Under the provisions of this secondary program, the Company could be assessed up to \$1,020,000 per nuclear incident involving any participating licensed reactor in the United States, subject to a maximum of \$2,040,000 in any year in the event of more than one incident. These figures will increase by \$510,000 and \$1,020,000, respectively, when Unit 3 receives its low-power operating license (now anticipated in March 1987). In addition, to cover possible damage to the PVNGS facilities, the PVNGS participants maintain nuclear property damage and decontamination insurance in the aggregate amount of \$1.23 billion, as of February 10, 1987. Insurance to cover a portion of the additional expense of replacement power resulting from an accident-related outage of PVNGS Units 1 or 2 is also provided.

Although the Company does not yet have an approved plan for decommissioning of PVNGS, the Company has filed a decommissioning plan with the NMPSC, which includes the establishment of a decommissioning trust, and expects a decision in the first half of 1987. The Company estimates the decommissioning cost for its share of PVNGS Units 1 and 2 to be \$365,000 per unit per year. The Company believes that all costs associated with nuclear plant decommissioning will be recoverable through rates charged to customers.

(12) Segment Information

The financial information pertaining to the Company's electric, gas and other operations for the years ended December 31, 1986 and 1985 are as follows:

	1986				1985			
	Electric	Gas	Other	Total	Electric	Gas	Other	Total
(In thousands)								
Operating revenues	\$ 443,084	\$244,666	\$ 10,245	\$ 697,995	\$ 408,101	\$273,737	\$ 8,144	\$ 689,982
Operating expenses								
excluding income taxes	295,799	223,205	5,242	524,246	227,228	250,899	4,891	483,018
Pre-tax operating income	147,285	21,461	5,003	173,749	180,873	22,838	3,253	206,964
Operating income tax	(8,224)	(606)	2,103	(6,727)	17,931	2,965	954	21,850
Operating income	\$ 155,509	\$ 22,067	\$ 2,900	\$ 180,476	\$ 162,942	\$ 19,873	\$ 2,299	\$ 185,114
Depreciation expense	\$ 50,567	\$ 8,916	\$ 766	\$ 60,249	\$ 47,113	\$ 7,515	\$ 738	\$ 55,366
Utility construction expenditures	\$ 178,230	\$ 19,689	\$ 2,112	\$ 200,031	\$ 242,559	\$ 17,675	\$ 1,697	\$ 261,931
Identifiable assets:								
Net utility plant	\$1,643,227	\$226,430	\$ 33,322	\$1,902,979	\$1,923,939	\$216,178	\$ 31,340	\$2,171,457
Other	427,598	78,260	347,307	853,165	460,514	92,352	285,915	838,781
Total assets	\$2,070,825	\$304,690	\$380,629	\$2,756,144	\$2,384,453	\$308,530	\$317,255	\$3,010,238

Prior to 1985, the Company had no material segments other than electric operations.

(13) Subsequent Event

Subsequent to December 31, 1986, a potential restructuring of the Company was announced which would include the formation of a holding company and the possible separation of the Company's electric utility operations into a generation entity regulated by the FERC and a distribution entity regulated by the NMPSC. Under this

arrangement, the generation entity would be committed to supply the projected power needs of the distribution entity under a long-term contract. Although details of any restructuring are subject to further study, it is anticipated that such restructuring, if implemented, may cause the Inventory of Capacity ratemaking methodology to no

longer be appropriate. The review of the prudence of PVNGS costs by the NMPSC would also be inappropriate, since the generation entity would not be regulated by the NMPSC.

The implementation of any restructuring would be subject to numer-

ous conditions, including required regulatory and other approvals.

The effect of the restructuring on the financial statements is not determinable pending resolution of the ultimate structure.

Quarterly Operating Results

The unaudited operating results (in thousands except per share amounts) by quarters for 1986 and 1985 are as follows:

Quarter Ended	Operating Revenues	Operating Income	Net Earnings	Earnings per Share
1986				
December 31	\$178,604	\$48,593	\$45,512	\$1.03
September 30	157,421	48,546	40,068	.90
June 30	162,591	41,059	32,727	.67
March 31	199,379	42,278	32,698	.68
1985				
December 31	\$174,766	\$53,360	\$46,205	\$1.07
September 30	166,650	52,822	43,131	1.00
June 30	159,969	37,683	26,400	.55
March 31	188,597	41,249	30,574	.68

In the opinion of management of the Company, all adjustments (consisting of normal recurring accruals) necessary for a fair statement of the results of operations for such periods have been included.

Stock/Dividend Data

Common Stock:

Range of sales prices of the Company's common stock, reported as composite transactions (Symbol: PNM), and dividends paid on common stock for 1986 and 1985, by quarters, are as follows:

	Range of Sales Prices		Dividends per Share
	High	Low	
1986			
Fourth Quarter	36¼	33	\$0.73
Third Quarter	37⅞	32½	0.73
Second Quarter	37⅞	30½	0.73
First Quarter	35⅞	28	0.73
Fiscal Year	37⅞	28	\$2.92
1985			
Fourth Quarter	30¾	26¾	\$0.73
Third Quarter	29½	25½	0.72
Second Quarter	28¼	25	0.72
First Quarter	25¾	23⅞	0.72
Fiscal Year	30¾	23⅞	\$2.89

The payment of future dividends will depend upon earnings, the financial condition of the Company, market requirements and other factors.

Cumulative Preferred Stock:

While isolated sales of the Company's cumulative preferred stock

have occurred in the past, the Company is not aware of any active trading market for its cumulative preferred stock. Quarterly cash dividends were paid on each series of the Company's cumulative preferred stock at their stated rates during 1986 and 1985.

Comparative Operating Statistics	1986	1985	1984	1983	1982
Electric Service:					
Energy Sales—kWhr (in thousands):					
Residential	1,353,933	1,319,529	1,279,917	1,205,046	1,134,827
Commercial	1,828,799	1,765,077	1,706,044	1,600,199	1,515,664
Industrial	842,030	788,880	762,117	742,272	784,158
Other ultimate customers	208,534	206,356	184,725	185,824	215,853
Total sales to ultimate customers	4,233,296	4,079,842	3,932,803	3,733,341	3,650,502
Sales for resale	869,017	1,156,268	2,384,535	2,371,860	2,840,957
Other contracted energy sales*	1,625,217	2,200,952	885,116	778,311	—
Total kWhr sales	6,727,530	7,437,062	7,202,454	6,883,512	6,491,459
Electric Revenues (in thousands):					
Residential	\$ 126,053	\$ 119,026	\$ 107,395	\$ 90,020	\$ 91,065
Commercial	163,820	152,921	134,532	107,729	110,745
Industrial	59,253	53,127	50,439	44,166	51,714
Other ultimate customers	14,622	14,293	11,950	10,913	14,775
Total revenues from ultimate customers	363,748	339,367	304,316	252,828	268,299
Sales for resale	71,412	60,421	131,013	136,273	149,115
Total revenues from energy sales	435,160	399,788	435,329	389,101	417,414
Miscellaneous electric revenues	7,924	8,313	3,645	2,846	2,743
Total electric revenues	\$ 443,084	\$ 408,101	\$ 438,974	\$ 391,947	\$ 420,157
Customers at Year-End:					
Residential	237,759	227,420	217,614	208,368	199,679
Commercial	28,735	27,053	25,614	24,259	22,148
Industrial	415	428	436	438	453
Other ultimate customers	213	216	194	186	185
Total ultimate customers	267,122	255,117	243,858	233,251	222,465
Sales for resale	6	6	6	5	6
Total customers	267,128	255,123	243,864	233,256	222,471
Reliable Net Capability—kW	1,565,000	1,305,000	1,337,000	1,343,000	1,473,000
Coincidental Peak Demand—kW	916,000	861,000	976,000	998,000	957,000
Average Fuel Cost per Million BTU	\$ 1.1710	\$ 1.2233	\$ 1.0970	\$ 0.9957	\$ 1.1502
BTU per kWhr of Net Generation	11,608	11,214	11,023	11,296	11,296
Water Service:					
Water Sales—Gallons (in thousands)					
Revenues (in thousands)	\$ 10,245	\$ 8,144	\$ 6,354	\$ 5,527	\$ 6,386
Customers at Year-End	18,820	18,240	17,717	16,721	20,432**

*Other contracted energy sales to utilities are accounted for as a reduction of fuel and purchased power expense rather than as operating revenue. Such energy sales generated \$77.8 million, \$86.0 million, \$22.9 million and \$20.8 million in 1986, 1985, 1984 and 1983, respectively.

**Includes 4,508 customers for the Las Vegas water system which was contributed to the City of Las Vegas on December 30, 1982.

Comparative Operating Statistics	1986	1985*
<u>Gas Service:</u>		
<u>Gas Sales—Decatherms (in thousands):</u>		
Residential	22,076	19,232
Commercial	10,762	9,642
Industrial	7,248	13,806
Other ultimate customers	10,899	10,779
Total sales to ultimate customers	50,985	53,459
Sales for resale	1,535	1,702
Total gas sales	<u>52,520</u>	<u>55,161</u>
<u>Gas Revenues (in thousands):</u>		
Residential	\$117,011	\$111,427
Commercial	45,867	45,519
Industrial	25,193	48,933
Other ultimate customers	37,435	44,719
Total revenues from ultimate customers	225,506	250,598
Sales for resale	5,675	6,638
Total revenues from gas sales	231,181	257,236
Miscellaneous gas revenues	13,485	16,501
Total gas revenues	<u>\$244,666</u>	<u>\$273,737</u>
<u>Customers at Year-End:</u>		
Residential	290,175	283,530
Commercial	28,218	27,435
Industrial	155	170
Other ultimate customers	3,776	3,860
Total ultimate customers	322,324	314,995
Sales for resale	11	10
Total customers	<u>322,335</u>	<u>315,005</u>

*Effective from acquisition date, January 28, 1985. Certain amounts have been reclassified for comparability.

Stockholder Information

Stock Plans

The Company's four Common Stock Plans were an important source of external funding for 1986. \$51 million was generated, providing the Company with approximately 35 percent of its total external financing needs. The plans are The Dividend Reinvestment Plan, The Employee Stock Purchase Plan, The Master Employee Savings Plan, and The Consumer Stock Plan.

Participation in the plans is made only by means of the appropriate prospectus. Prospectuses are available by writing to the Company or telephoning (505) 848-2122 (local), 1-800-432-4494 (New Mexico), or 1-800-545-4425 (outside New Mexico).

Stockholder Communications

Duplicate Mailings

Due to Securities and Exchange Commission regulations, the Company is obligated to mail financial information to each shareholder account of record. If a single household owns stock under several accounts, however, each account at the same address will be individually mailed all financial information. Upon written notification to the Company, duplicate mailings to the same address can be eliminated.

Certificate Registration Inquiries

To notify the Company of any changes of address, changes in certificate registration, or lost certificates, please write to:

Public Service Company of New Mexico
Stockholder Services
Alvarado Square - MS 0082
Albuquerque, NM 87158

Questions and Comments

The Company welcomes any questions and comments shareholders may have regarding PNM or any information appearing in the Annual and Quarterly Reports. Please direct any correspondence to:

Stockholder Information

Karen A. Knight
Assistant Secretary and Manager, Stockholder Services
Alvarado Square - MS 0082
Albuquerque, NM 87158

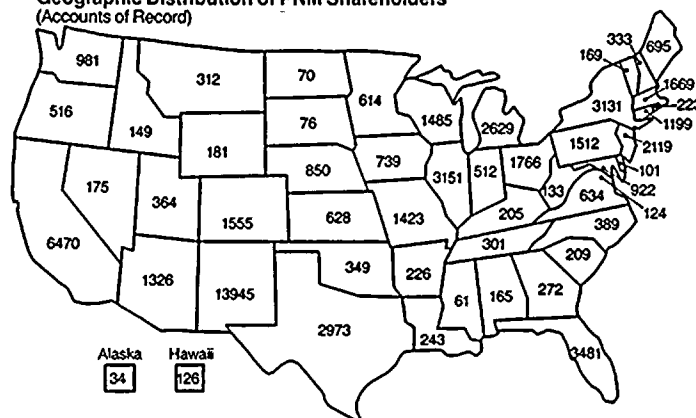
Financial Information

Valerie C. Cheeseman
Director, Investor Relations
Alvarado Square - MS 0260
Albuquerque, NM 87158

Stockholder Meetings

Beginning in October senior management of PNM began a series of meetings with New Mexico shareholders. The meetings provided a forum for investors and presented updates on Company events. Approximately 900 shareholders attended. More meetings are planned in 1987.

Geographic Distribution of PNM Shareholders
(Accounts of Record)



Form 10-K

For copies of the Company's 10-K filed with the Securities and Exchange Commission, please contact J. B. Mulcock, Jr., Secretary, Public Service Company of New Mexico, Alvarado Square, Albuquerque, NM 87158.

Stock Exchange Listing

Common Stock of the Company is listed on the New York Stock Exchange under the symbol PNM.

Transfer Agents

Common Stock

Public Service Company of New Mexico Stockholder Services
Harris Trust Company of New York

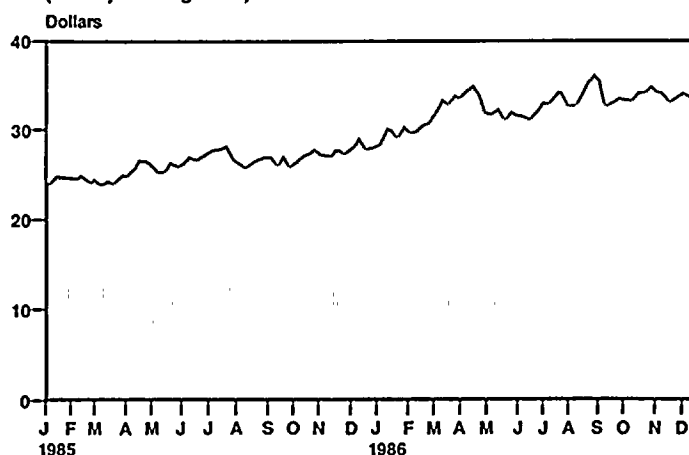
Preferred Stock

Public Service Company of New Mexico Stockholder Services

Registrars

First National Bank in Albuquerque
Harris Trust Company in New York

1985-1986 PNM Common Stock Price
(Weekly Closing Price)



Directors and Officers

Board of Directors

John P. Bundrant**

President and Chief Operating Officer
Electric Operations
Public Service Company of New Mexico

Ashton B. Collins, Jr.

President
Reddy Communications, Inc.
Albuquerque, NM

Jerry D. Gelst†**

Chairman and President
Public Service Company of New Mexico

Claude E. Leyendecker*

Chairman of the Board and
Chief Executive Officer
United New Mexico Bank at Mimbres Valley
Deming, NM

Arturo G. Ortega*

Attorney at Law
Ortega & Sneed, P.A.
Albuquerque, NM

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Robert O. Anderson Graduate
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University of New Mexico
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