PNM Annual Report 1987

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-NOTICE-

" Today the utility industry
crossroads. Investors, manage
alike face fundamental choic
or more regulation, new for
The choices we make now w

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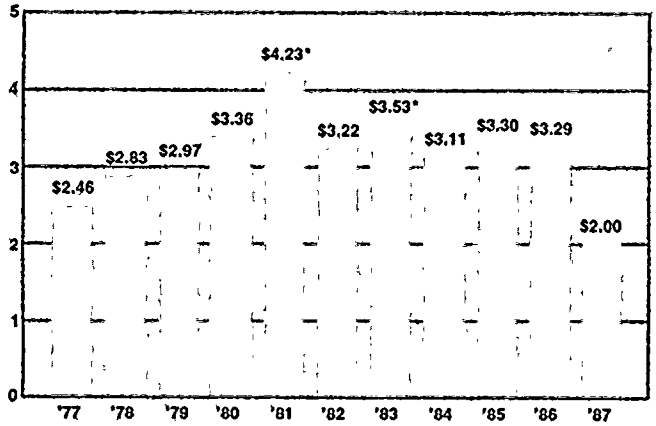
Public Service Company of New Mexico and Subsidiaries

Operation Summary	1987	1986	% Change
Operating revenues	$ 689,656,000	$ 697,995,000	(1.2)
Operating expenses	$ 557,305,000	$ 517,519,000	7.7
Net earnings	$ 95,389,000	$ 151,005,000	(36.8)
Return on average common equity	7.7%	12.8%	(39.8)
Earnings per common share	$ 2.00	$ 3.29	(39.2)
Dividends paid per common share	$ 2.92	$ 2.92	—
Book value per common share at year-end	$ 25.68	$ 26.51	(3.1)
Utility construction expenditures	$ 121,963,000	$ 200,031,000	(39.0)
Electric:			
Total kilowatt-hour sales*	6,938,724,000	6,727,530,000	3.1
Gas:			
Decatherm deliveries**	55,434,000	54,765,000	1.2

*Includes other contracted energy sales of 1,661,095,000 kWhr and 1,625,217,000 kWhr in 1987 and 1986, respectively. These sales are accounted for as a reduction of fuel and purchased power expense rather than operating revenue.

**Includes 5,149,000 decatherms and 2,245,000 decatherms of transportation deliveries in 1987 and 1986, respectively.

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.

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

To the Stockholders:

1987 was a bad year.
Net earnings applicable to common stock were $83.5 million, or $2.00 per share, compared with $132.8 million, or $3.29 per share in 1986. Our stock price reached a high of $39.25 on March 13, 1987 during the Wall Street bull market. We closed the year at $18.75.

The Board of Directors on January 27, 1988 declared a fourth quarter dividend of $.73 per share, or $2.92 for the year. When we filed our reorganization and restructuring case with the New Mexico Public Service Commission in August 1987, the Board of Directors announced that there was no plan to change its dividend policy, but that the proposed holding company's dividend policy would be evaluated after restructuring. However, the public service commission proceedings have not moved along as rapidly as we had hoped. Opposition to our plan has been expressed by various parties, and alternative restructuring proposals are under consideration. Inasmuch as regulatory approval of any restructure will take longer than anticipated, the Board will reevaluate dividend policy at its April meeting.

That's the bad news.

The good news is that we are working hard to turn your Company around and are making progress. To measure that progress, let's revisit what I wrote in last year's annual report.

THE 1986 REPORT REVISITED
First, I noted that of our $3.29 per

share earnings in 1986 "a series of tax benefits, which are not expected to recur at the same high level in future years, contributed $1.03 per share." Those tax benefit levels did not recur in 1987.

Second, I outlined the economic slump we faced due to the collapse of New Mexico's uranium industry, the recession in the coal, oil and gas industries, international competition faced by Albuquerque's electronic industries, and difficulties in attracting new industries to New Mexico. These circumstances were compounded by a wholesale power market awash in excess capacity, caused in part by regional utilities bringing back on line previously mothballed oil-fired capacity that became economic as oil prices plummeted. None of these conditions improved during 1987.

Third, I discussed regulatory setbacks, the most critical of which were proposed changes in national accounting standards that could adversely affect "inventorying of capacity," the ratemaking method for dealing with our excess generation capacity. In August 1987 the Financial Accounting Standards Board adopted those rules. While they did not affect inventorying in 1987, the new rules will require significant changes in excess capacity ratemaking for future years.

Fourth, I alluded to "far-reaching changes" in the gas and electric utility industries—deregulation, the breakdown of the "regulatory compact" between utilities and their customers, growth of independent energy producers, and the emergence of competition among utilities—which were changing our operating environment.

Finally, I set down in last year's letter our "Agenda for Tomorrow":

- Becoming one of the lowest-cost providers in our region;
- Becoming a holding company and then restructuring our utilities;
- Expanding our non-utility investments in telecommunications manufacturing, financial services, and real estate; and
- Making an even stronger commitment to business and economic development in New Mexico and the Southwest.

PROGRESS DURING 1987

Now, how much of that agenda has been accomplished, and what are we doing to turn around our financial outlook? Let's review each of our businesses:

The Electric Utility: Making and selling electricity is our core business, and is the one in which we face the toughest challenges and on which our turnaround efforts are focused.

Electric operations account for 77% of our total capital investment and 68% of total revenues. Our basic problem is that our traditional market has not grown fast enough to require the full electricity supply we had to plan for more than a decade ago—well before New Mexico economic growth slackened. But growth will resume and New Mexico and the Southwest will need more electricity. When growth occurs we want to be well positioned to supply the needed electric power.

In order to get to that position, we are pursuing our restructuring plan vigorously, the two principal objectives of which remain to be accomplished:

- To secure regulatory approval for our reorganization as a holding company; and
- To secure public service commission approval to restructure our electric utility into a distribution entity and a wholesale generation and transmission entity.

Our restructuring proposal was publicly unveiled in February 1987. We then solicited extensive public input, after which we filed an improved plan with the PSC in August. The PSC scheduled formal hearings on our proposal for October 1988. However, it also left open a fast track approval process if interested parties can reach a settlement agreement.

An alternative plan offered by the PSC staff in January 1988 may provide the basis for such a fast track settlement. While the PSC staff plan is significantly different from PNM's, it addresses many of the concerns expressed by the New Mexico Attorney General, and achieves most of the same objectives as does PNM's original proposal:

- A viable means of selling excess capacity through creation of a special non-state regulated entity to market wholesale power;
- A long-term revenue stream to meet debt obligations, and to achieve a modest and stable level of earnings;
- Immediate rate cuts for all cus-

tomers, and economic development incentive rates for new or expanding businesses;

- A means of achieving rate stabilization; and
- A holding company corporate structure.

As this annual report goes to press we hope that reasonable parties can agree on such a program. An equitable fast track solution would help us accelerate the turnaround of electric operations.

The Gas Utility: There have been rapid and dramatic changes in the gas industry in recent years—wellhead prices deregulated, interstate pipelines opened, open-access transportation, and supply security sacrificed for spot market price savings. Despite a 26% reduction in gas bills to customers, gas operations continued to lose volume.... and to make inadequate contributions to earnings.

In August 1987 we filed an $18.4 million rate increase request with the PSC. In December we also filed a new contract between Gas Company and Gathering Company which properly prices peak-season gas.

We hope to conclude regulatory actions this summer. Assuming the PSC approves them, they should contribute to solid, stable natural gas earnings.

CUTTING LOSERS, BUILDING WINNERS

Years of experience in diversified mining and investment businesses have taught us some valuable lessons.

First, our mining investments will be limited to coal properties in support of power plants, a business we know well. As a result of this new focus, in 1987 we sold our gold mining interests to Royal Gold, Inc., and have ended other mineral and precious metal involvements. We are looking to reduce further our involvement in coal mining.

Second, Meadows Resources is now focusing on telecommunications manufacturing and real estate. We are reducing or eliminating operations not in those areas. We have scaled back our venture capital program. Meadows lost money in 1986 and 1987 after strong earnings in 1984 and 1985, largely due to losses from the Montaña de Fibra fiberboard operation. The recession has hit hard at Southwest land sales, and even though we essentially broke even in real estate operations, the next several years will be difficult.

POSITIONING FOR THE FUTURE

We are going back to basics. We have largely fixed the problems in our water business, and are well on our way to solving the problems in our gas business. In 1988 and beyond we will be concentrating on the difficult, long-term challenges in electric power. Under the PNM plan or the PSC staff's alternative, or a variation thereof, we hope to have a wholesale power subsidiary to help us to compete more effectively.

In July we proposed—unfortunately, unsuccessfully—to merge with Utah Power and Light in order to create a large, strong and efficient regional generation and transmission company capable of competing aggressively throughout the West.

We established with Los Alamos National Laboratory an advanced studies program in high temperature superconductivity under Nobel Laureate Robert Schrieffer because new discoveries in superconductivity may help to lower power costs again.

Today the utility industry stands at a crossroads. Investors, managers and regulators alike face fundamental choices—more competition or more regulation, new forms of organization or old. The choices we make now will shape PNM for the future.

The problems we face in 1988 are long-term ones. In 1987 we addressed them and made a strong start toward turning PNM around. We are confident that the turnaround will occur and trust you share our confidence.

Sincerely,

Jerry D. Geist
Chairman and President
February 29, 1988

1987–Milestone Year For Electric Operations

This past year marked the 70th year of PNM's partnership with New Mexico. It was also a year influenced by the challenge of increased surplus generating capacity. In 1987, PNM proposed to restructure our electric operations to meet the current marketing challenges and to achieve a more favorable competitive position for the future in our changing industry. We also exceeded mid-term goals of our three-year cost control plan and developed a marketing foundation for growth.

EMPLOYEES HAVE MAJOR ROLE IN CONTROLLING COSTS
In 1987 we were operating at the lowest staffing level in almost a decade, relying on a lean and dedicated work force to meet our marketplace's increased needs. This staff reduction was part of the three-year cost control plan we developed in 1986. In 1987 our employees were responsible for implementing measures that helped us reduce expenses by $23.5 million.

Employees were also responsible for fundamental changes in the way we operate our business. In particular, personnel at San Juan Generating Station demonstrated exceptional initiative in forming major cost reductions. For example, current market conditions and maintenance scheduling allow us to use more PNM employees and fewer contractors on unit overhauls thus achieving major savings when compared to previous overhauls.

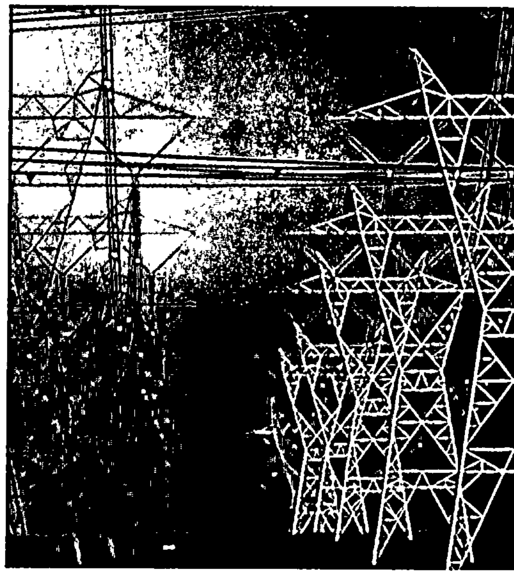
PALO VERDE—"ENERGY CORNERSTONE OF THE SOUTHWEST"
In November 1987 the third and final 1270 MW unit of the 3810 MW Palo Verde Nuclear Generating Station began power production. The plant attained commercial operation on January 8, 1988, completing systems check-out procedures in 43 days—an industry record. Energy Secretary John S. Herrington dedicated the Palo Verde facility as the "Energy Cornerstone of the Southwest," reflecting Palo Verde's key role in a shift away from future U.S. dependence on oil-fired generation.

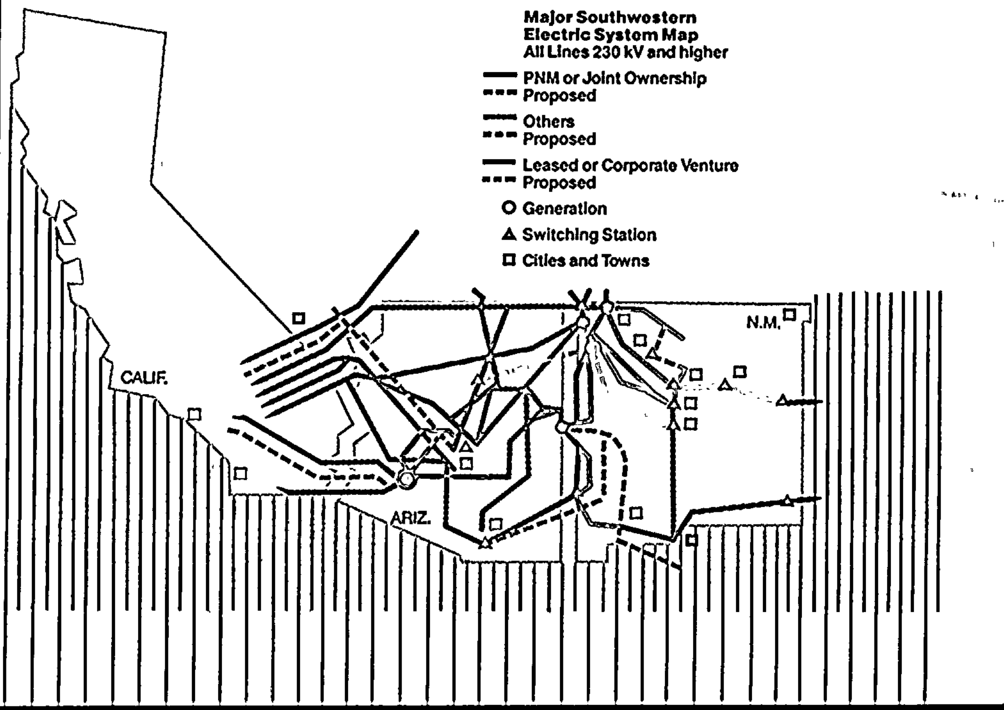
SERVICE, INFORMATION, CHOICE—A MARKETING FOUNDATION
In 1987 we laid the foundation for our marketing strategy. That strategy is based on satisfying our customers in order to maintain and enhance market share during this period of increasing competition.

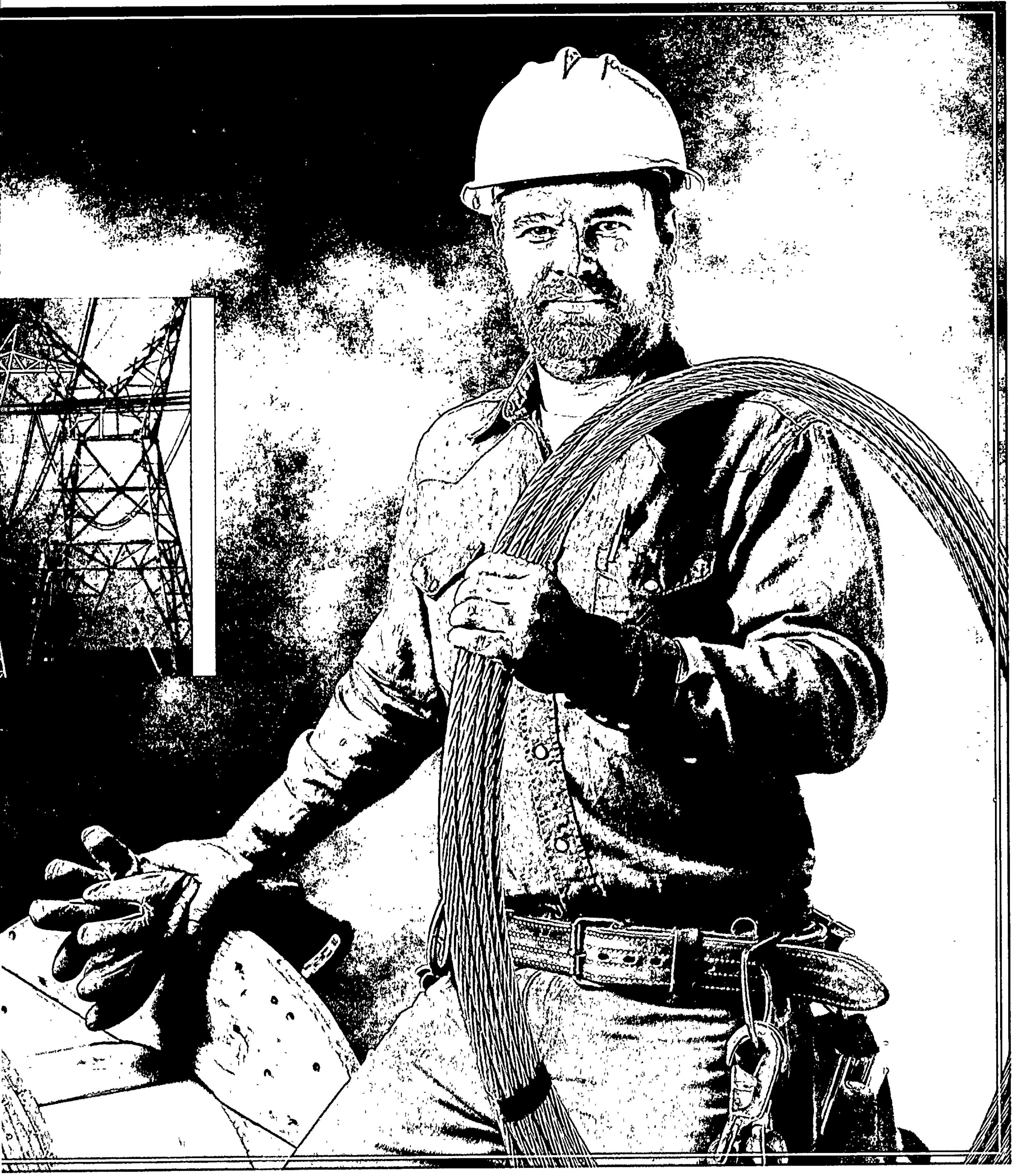
We signed 25-year franchise extensions in our Clayton and Deming divisions. This year significant discussion also began regarding our Albuquerque franchise which expires in 1992. We remain committed to serving the Albuquerque area.

In 1987 we opened our seventh neighborhood office in the greater Albuquerque area. PNM now has a total of 15 offices in our system. Each is staffed with selected and trained employees to serve as personal account representatives offering greater levels of service, information and energy choice. More personal service to satisfy customer needs is paying off through efficient and timely settlement of customer complaints.

"Installing and maintaining PNM's residential and commercial distribution system is the backbone of the electric company. Without that, there's no juice to power homes." Ronald Mitchell is a 15-year veteran with the Albuquerque Line Department, a Foreman with the underground maintenance and construction crew. "I enjoy my work," says Mitchell, "because I like working with my hands. Line work is always changing, so there is always something new to learn."







CUSTOMER RETENTION—
A TOP PRIORITY

Employee-initiated programs are an important element of our corporate strategy. One program offers floodlights to our customers for a flat monthly fee covering installation, maintenance, and electricity costs. This market strategy is one of many ways we use products to establish business contacts. Account representatives follow up on contacts those programs create. This personal service helps increase retail sales and meet competition.

Personal service is also especially important in business relationships with customers who are increasingly offered other energy choices. Options such as cogeneration and self-generation have entered the marketplace and have caused a reduction in sales. In 1987 about 5 MW of cogeneration were installed in our service area. In order to meet this competition, PNM employees analyze customer energy needs, evaluate proposals from competitors, and suggest alternatives.

Other efforts promote the use of electricity and electrical equipment to supplant equipment powered by competing fuels. One program offers rebates to food service establishments which install electric cooking equipment. Another program offers similar incentives to housing developers installing electric appliances.

EXPERIMENTAL POWER POOL
GIVES PNM COMPETITIVE
MARKET EXPERIENCE

While soft wholesale power markets continue, we anticipate a firmer wholesale market by the mid- to late-1990s. In view of this, PNM is participating in the Western Systems Power Pool, a pool connecting 24 utilities in the U.S. and Mexico. Our participation in this flexible pricing experiment featuring both power and transmission (wheeling) increased the Company's "spot" energy sales by ten percent last year and also generated wheeling revenues.

The past year placed exceptional demands on our employees in continuing the tradition of responsive innovation and community support that has been the hallmark of our first seven decades of existence. We look forward to meeting the challenges of the future.

Gas Operations – Preparing For The Future

Gas Company of New Mexico now serves about 330,000 customers throughout New Mexico. Gas Company and two affiliates, Sunterra Gas Gathering Company and Sunterra Gas Processing Company, comprise gas operations with options most local distribution companies (LDCs) do not possess. These affiliates are owned through PNM's subsidiary, Sunbelt Mining Company, Inc.

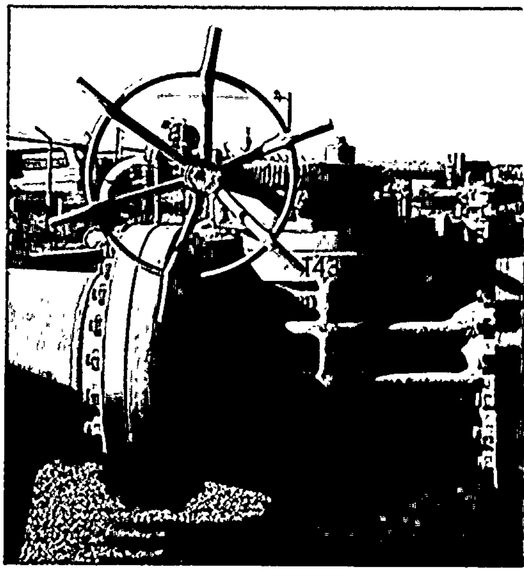
In 1987 Gas Company had decreased natural gas sales because of regulatory constraints, increased competition and open-access transportation. Our goal is to change regulatory constraints affecting our ability to compete with other, unregulated gas transporters. This year we worked towards a better competitive position through a series of filings with the New Mexico Public Service Commission.

NEW RULES IMPACT SERVICES
AND COMPETITION

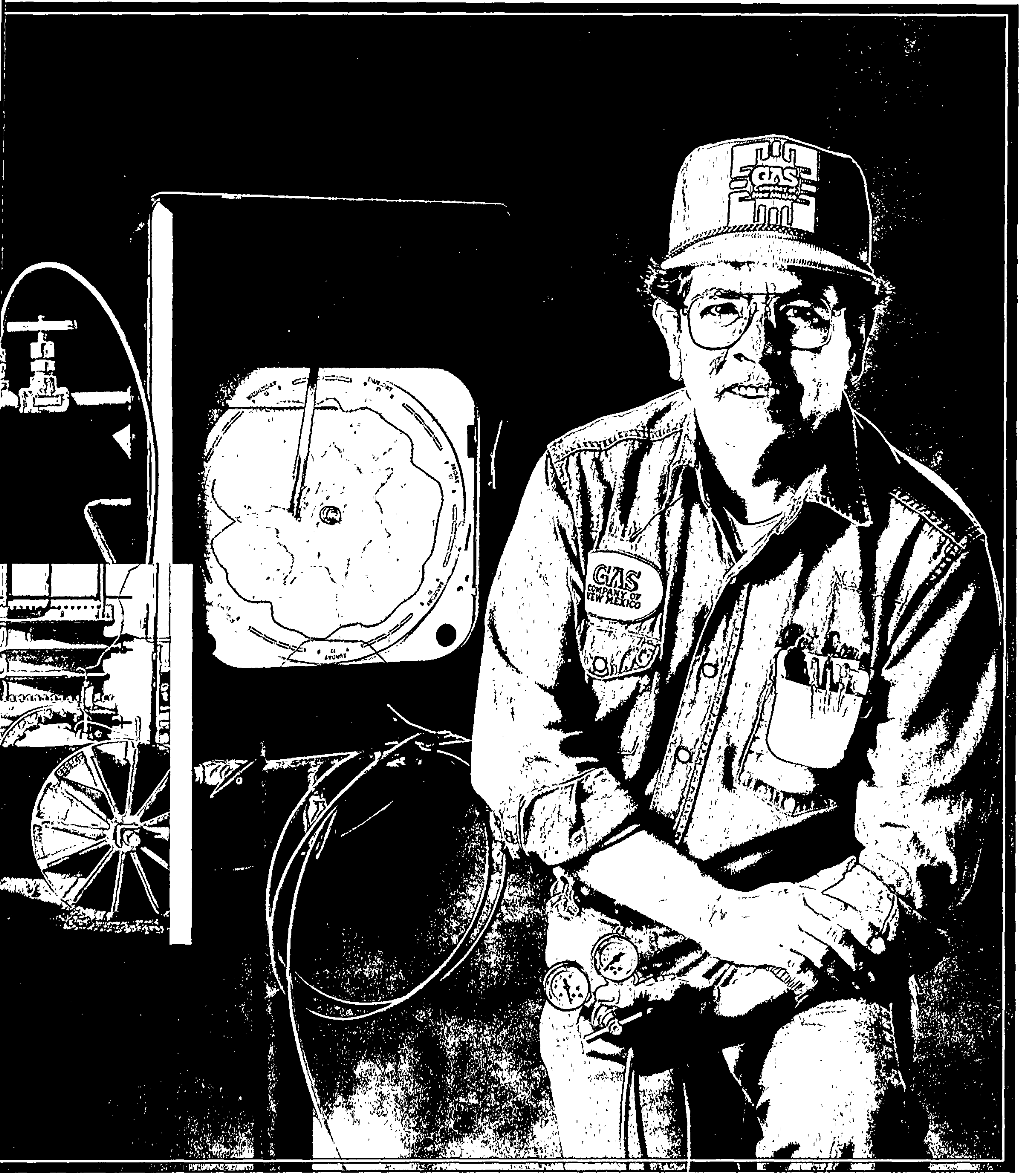
In the past, gas utilities were charged with the legal obligation to provide continuous, long-term service to all customers. In turn, regulators allowed relatively consistent rates of return. Now, NM regulations promote increased competition for gas supplies, allowing users to purchase gas from others and requiring Gas Company, for a fee, to transport these volumes.

In December 1987 the Public Service Commission revised transportation guidelines. These revisions responded to many of Gas Company's concerns. However, they also permit most customers to choose an alternate gas supplier starting in December 1987. As of December 1988 residential customers will also be allowed to choose their gas suppliers. These revisions increase the potential for third-party gas to be transported on our system as customers seek alternative supplies.

In 1988 Gas Company could be transporting third party gas equal to an estimated 20% of 1988 total deliv-



As Senior Measurement Technician, Pat Dominguez monitors gas pressures and volumes. "I must be completely familiar with all regulating equipment throughout Albuquerque," says Dominguez. "Accurate measurement, regulation of line pressures and keeping Albuquerque supplied with gas are my main responsibilities."


GAS
COMPANY OF

eries. The Public Service Commission has removed Gas Company's obligation to provide back-up gas for transportation customers who do not elect stand-by service and gave Gas Company discretion in providing back-up gas to these customers.

GAS RATE CASE FILED

In August Gas Company filed a rate case with the Public Service Commission requesting an increase in annualized gas utility revenues of approximately $18.4 million. This request is based on increased cost of service since 1983 and a redesign of "unbundled" rates. We have proposed to separate and individually price all our gathering, processing, transportation and distribution services - available in any combination - for any customer with access to our system. Even with proposed increases, Gas Company will continue to rank among the nation's lowest cost distribution companies.

Johnny R. Johnson, Rate Manager with Gas Company of New Mexico—"Gas rates have to respond to a variety of needs. They have to cover our costs, be fair to our customers, and provide shareholders a good return on their investment."

STRATEGY SEEKS TO BALANCE GAS SUPPLY, DEMAND

Since 1985 Gas Company has experienced large losses of industrial customers who have left the system or contracted for their own source of supply. As a result, the Company's business is now driven by residential loads resulting in sharp, short winter peak sales, and low-volume sales, for the rest of the year.

However, when Gas Company was acquired in early 1985, PNM inherited long-term supply contracts, with *take or pay* provisions not matched to current volatile sales volumes. Take or pay provisions are common in natural gas supply contracts and typically require the buyer to *pay* for minimum gas amounts regardless of amounts actually *taken* from the producer. Gas Company and Gathering Company are disputing claims by producers relating to both contract pricing and take or pay obligations, some of which are the subject of pending litigation against the companies. Consistent with historic practices, the Company has sought and will continue to seek to recover from its customers, through various rate mechanisms, any amounts ultimately paid to producers. In late December Gas Company filed a supply strategy report seeking new regulatory provisions that would allow us to match gas supply contracts more closely with expected consumption levels.

SUPPLY RENEGOTIATIONS CONTINUE, LOWERING COST

We continued to renegotiate our supply contracts with producers. Since 1985, Gas Company and Gathering Company have been renegotiating their supply contracts. Contract renegotiation and other actions have resulted in a 40% gas price reduction, contributing to some of the lowest delivered costs in the nation.

Diversified Operations Attain Major Goals

Meadows Resources—Building Value for the Future

Diversification through Meadows Resources, Inc. is designed to improve long-term earnings for shareholders and to enhance electric and gas load growth in our utility service areas.

In 1987 we concentrated our investment activities primarily in two areas—telecommunications and real estate. This year our telecommunications companies recorded solid

Janice Breeze, Telecommunications Investment Manager, Meadows Resources, appears with cellular phone antennas, using Alliance components. Says Breeze, "Because I was involved in the initial analysis and later, the final investment decision to fund Alliance, it has been rewarding for me to watch their antenna products sales growth. We are enthusiastic about the opportunities for Alliance."

Christopher Worthing (inset), Investment Manager for Meadows' telecommunications unit, provides business analysis for Alliance and other telecommunications investments.

growth. We also made several additional venture capital portfolio investments. While still operating at a loss, our Montaña de Fibra medium-density fiberboard manufacturing company, in Las Vegas, NM, showed significant improvement. Several new production and shipment records were established during 1987. Montaña de Fibra has contributed significantly to the local economy, and represents the largest new industrial customer to enter PNM's electrical system in the last four years.

TELECOMMUNICATIONS INVESTMENTS CONSOLIDATED

In 1987 Meadows increased its investment in Decibel Products, Inc., a manufacturer of antenna systems, and merged it with another investment, Alliance Telecommunications Corporation, a manufacturer of paging and mobile telephone switching equipment. Alliance has become a significant competitor in the wireless telecommunications equipment industry. Alliance's goal is to serve as a worldwide vendor of wireless telecommunications products for regional Bell companies, private and public wireless communications systems and other related markets. In 1987 sales for Alliance were $43 million—a record sales year.

Our other investments in this industry, Plexsys and Quintron, manufacture cellular switching equipment and radio frequency transmitters. A merger between Alliance and Quintron is now under discussion.

REAL ESTATE INVESTMENTS INCREASE

Our 1987 real estate business suffered a downturn due mainly to weak southwest real estate markets. But, adhering to long-term strategy, we continued participation in several major real estate projects.

The second construction phase began in late 1987 at Centrelake Business Park, a 70 acre office/retail/hotel development in the fast-growing Ontario, California airport area.

Construction started at Forest Highlands, a golf and residential development near Flagstaff, Arizona.

We and our partner purchased land in Santa Fe, NM for the Santa Fe County Ranch Resort. We began discussions with parties interested in investing in this development. Plans include residences, a corporate management center (The Santa Fe Center), a resort hotel, golf course and health and wellness center.

Bellamah Community Development saw declines in some of its markets. Bellamah, a partnership, represents the major real estate investment vehicle of Meadows.

FINANCIAL SERVICES GROW

Meadows is a 50 percent owner of MCB Financial Group, Inc., a financial services company with assets of $169 million. MCB's principal subsidiary, Republic Savings Bank in Chicago, showed profitability in 1987.

NMBI—SPECIAL UNIT CREATES NEW MEXICO BUSINESS INITIATIVE

We also created the New Mexico Business Investments (NMBI) unit to stimulate in-state capital formation, to complement Meadows' other operations and to enhance electrical and natural gas demands. NMBI's goal is to improve the state's business and economic climate and also to work with national scientific laboratories, high tech companies and others interested in transferring R&D technology to practical applications.

NMBI invests in expanding New Mexico companies as well as out-of-state companies that locate their operations in NM. NMBI plays a key liaison role in attracting needed capital from NM or out-of-state investors.

During the first six months of operation NMBI has evaluated more than 12 companies and committed to invest in three. The unit is active in New Mexico and national economic development planning. This year, as a result of NMBI's efforts, Lukens Corporation, a New Jersey surgical needle and suture manufacturer, elected to come to Albuquerque, a relocation which has the potential to create several hundred New Mexico jobs.

Natural Resources Reaches Milestones

In 1987 Sunbelt Mining Company, Inc. and its subsidiaries achieved major milestones. A subsidiary disposed of its gold operations in exchange for stock of Royal Gold, Inc., enabling about a 25% corporate staff reduction. However, disappointing performance in mining resulted in overall losses for Sunbelt.

Sunbelt's new Sunterra Gas Processing Company completed a successful first year of operations. Another subsidiary, Sunterra Gas Gathering Company, realized slight improvement in 1987 financial performance from a 1986 break-even year. Additional improvement is expected to occur in 1988.

Sunbelt's Totah Power Development Company, Inc. and affiliates of Bechtel Power Corporation, the Navajo Nation, and Combustion Engineering, Inc. have formed a partnership to study development of the Dineh power plant. The coal-fired generating plant would be on Navajo land in northwestern New Mexico. Construction would not begin until agreements have been signed to sell Dineh power in the 1990s.

In New Mexico, Sunbelt produced about 225,000 tons of coal and in Oklahoma a coal subsidiary produced almost 800,000 tons. Poor market conditions and expensive equipment renovation in Oklahoma were major contributors to disappointing performance. With equipment renovations completed, coal operations' financial performance is expected to improve in 1988.

PNM'S EXECUTIVE OFFICERS
Front Row: Albert J. Robison, Jerry D. Geist
Middle Row: James F. Jennings, Jr., James B. Mulcock, Jr.
Back Row: John T. Ackerman, John P. Bundrant

"The problems we face in 1988 are long-term ones. In 1987 we addressed them and we are making progress."

Financial Data and Consolidated Financial Statements

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

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 the potential reorganization and restructuring of the Company discussed below.

Liquidity and Capital Resources

Major Generation Construction Completed

The commercial operation of the third and final unit of the Palo Verde Nuclear Generating Station (PVNGS) on January 8, 1988 signals the end of the Company's major generating plant construction program which was begun in the late 1960s. Utility construction expenditures have declined significantly and will continue in the foreseeable future to be lower than the levels experienced during the late 1970s and early 1980s, and are expected for the years 1988-1992 to consist primarily of upgrade and expansion of the electric transmission system and distribution systems.

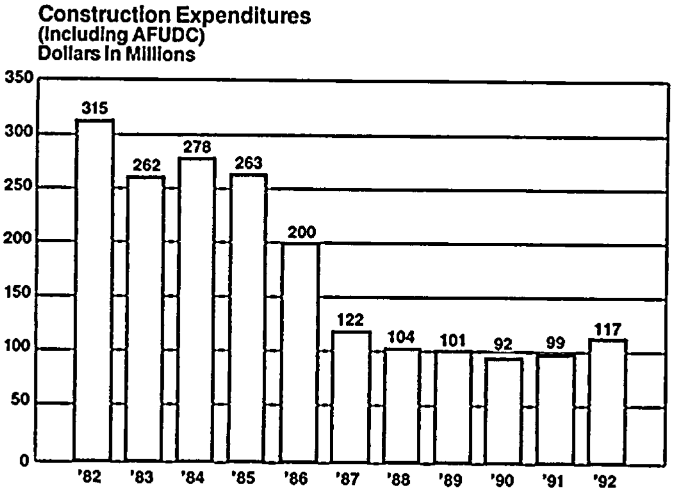
Over the next five years (1988-1992), the Company expects to incur $513 million of construction expenditures for the electric, gas and water utilities. This amount includes $14 million in "allowance for funds used during construction," a non-cash item that reflects the Company's costs of debt and equity capital used to finance utility construction, and $68 million for the purchase of nuclear fuel. The Company currently has no material capital commitments beyond 1992 which would significantly differ from the levels reflected in the five year utility construction projections.

Utility Construction Expenditures; A Five Year Projection

Actual utility construction expenditures for 1987 and the Company's projections for 1988-1992 (in millions of dollars) are shown below:

	1987	1988	1989	1990	1991	1992
Cash	$ 88	$100	$ 99	$ 89	$ 97	$114
AFUDC	34	4	2	3	2	3
Total	$122	$104	$101	$ 92	$ 99	$117

The Company conducts a continuing review of its construction program. This program and the above estimates are subject to periodic revisions based upon changes in assumptions as to system load growth, rates of inflation, the availability and timing of environmental and other regulatory approvals, the availability and costs of outside sources of capital and changes in project construction schedules. The Company has in the past revised its construction budget in light of such factors and will effect further revisions in the future.



Other Major Cash Requirements

The Company's other major cash requirements include, among other things, payments of long-term debt maturities and mandatory redemptions of preferred stock (together, $24.0 million for 1988 and $87.1 million for 1989-1992) and annual lease payments of $84.6 million for the Company's leasehold interests in PVNGS Units 1 and 2.

Liquidity

The Company's ability to generate cash from operations is under increasing pressure from costs associated with substantial generation plant not in New Mexico retail ratebase, a soft market for wholesale electric power sales, increased competition from alternative sources and suppliers of energy and other factors. (See "Restructuring Proposals; A Response to Issues Facing the Company" below.)

Efforts to boost the Company's internal cash generation include continuing cost control programs, an $18.4 million gas rate case filed in August 1987, increased efforts to market electricity at both retail and wholesale, and the examination of various alternatives for earning a return on the Company's PVNGS investment. The Company's diversification program through Meadows Resources, Inc. is intended to improve earnings and cash flow over the long-term period, and to improve load growth in the Company's utility service area.

The Company had $24 million in cash and temporary cash investments at the end of 1987, compared to $259 million at the end of 1986. In addition, at December 31, 1987, the Company had approximately $200 million in a long-term investment portfolio which the Company plans to maintain over the next five years.

A significant factor affecting the Company's internal cash flow is payment of dividends on the Company's common stock. On January 26, 1988, the Company's Board of Directors declared a quarterly dividend which was unchanged from the dividend declared in recent quarters. The Company stated at that time, however, that its dividend policy would need to be carefully evaluated at the Board's next regular meeting and would have to take into account the Company's earnings, financial and marketing conditions, the status of the reorganization and restructuring of the Company (see "Restructuring Proposals; A Response to Issues Facing the Company" below) and other factors existing at that time.

Capital Resources

The Company currently projects that during 1988, it will raise approximately $1.7 million through the issuance of common stock through the Company's consumer stock plan, draw down the remaining $5 million in a pollution control trust fund and, to the extent necessary to meet any additional funding requirements, incur short-term debt. At the end of 1987, the Company had available, for short-term borrowings, unused credit commitments from various banks of approximately $324.5 million. Due to, among other things, uncertainties surrounding the Company's proposed reorganization and restructuring, the Company cannot currently estimate the amounts of external funds that it will need to meet funding requirements in 1988 or in future years.

The Company can also raise external capital, upon New Mexico Public Service Commision (NMPSC) approval, by issuing common stock and, provided certain tests specified in the Company's mortgage indenture and Restated Articles of Incorporation are met, first mortgage bonds and preferred stock. As of December 31, 1987, these tests did not restrict the Company's ability to issue additional first mortgage bonds or preferred stock in amounts adequate to fund its planned construction program for 1988 through 1992. The Company, however, currently has no plans to issue additional first mortgage bonds, preferred stock or common stock other than common stock issued through the consumer stock plan. In addition, the Company's ability to raise external capital and the cost of such funds depend upon financial market conditions, earnings and credit ratings, among other factors. In 1987, major rating agencies lowered the Company's securities ratings, which could potentially increase the cost of new capital. External funding requirements for 1989 through 1992 are expected to be met largely through short-term debt borrowings.

The Company's capital structure at December 31, 1987 consisted of 42.8 percent long-term debt, 2.9 percent preferred stock with mandatory redemption requirements, 2.8 percent preferred stock without mandatory redemption requirements and 51.5 percent common stock equity.

The Effects of the New Tax Law

The Tax Reform Act of 1986 has had the effect of generally decreasing the Company's income tax expense in total while at the same time increasing the portion of such expense which is currently payable. While such tax law reduced the corporate federal income tax rate from 46 percent in 1986 to 40 percent in 1987 and 34 percent thereafter, several other provisions, including the elimination of the investment tax credit for property acquired or constructed after 1985, taxing of revenues for utility services rendered but not yet billed and the enactment of the new alternative minimum tax, result in reduced cash flow for the Company.

Results of Operations

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

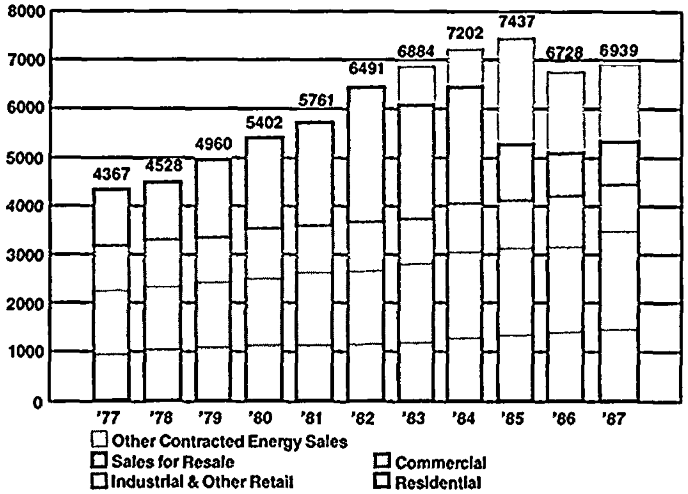
1987	1986	1985
$83 million or $2.00 per share	$133 million or $3.29 per share	$122 million or $3.30 per share

Earnings declined significantly in 1987, primarily as a result of certain tax benefits recognized in 1986 and the commercial operation of PVNGS Unit 2 for a full year in 1987. Currently, the commercial operation of the PVNGS units has several adverse effects on the results of operations as discussed below. The following discussion highlights significant items which affected the amount of reported earnings in 1987 and certain items which may continue to affect earnings in the years beyond. Additional discussion of items potentially affecting the Company's future results of operations is included under "Restructuring Proposals; A Response to Issues Facing the Company" below.

Electric operating revenues increased $25.0 million in 1987 over 1986 primarily as a result of a 7.0 percent increase in energy sales to residential and commercial customers. The $35.0 million increase in 1986 was caused largely by a 6.1 percent increase in energy sales to commercial customers and to increased revenues from San Diego Gas and Electric Company for the increased capacity made available to it by the Company.

Gas operating revenues declined $34.0 million and $29.1 million in 1987 and 1986, respectively. These decreases were due primarily to lower gas purchase costs which are recovered from customers through a purchased gas adjustment clause. The loss of a major industrial customer in June 1986 also contributed to the decrease. Gas operating revenues were also impacted by 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. All of GCNM's customers (including, after December 1988, residential customers) have this option open to them. The Company does not expect that a shift of customers from traditional gas service to transportation gas

Total kWhr Sales
kWhr in Millions



service will have a material adverse effect on earnings.

Fuel and purchased power expense, which is reduced by off-system energy sales to other utilities, decreased $4.1 million in 1987 and increased $3.9 million in 1986. The 1987 decrease is due primarily to a $12.7 million decrease in net purchased power expense resulting from a price increase for other contracted energy sales to other utilities. The 1986 increase was due to a soft off-system energy market, a result of inexpensive oil and gas generation availability.

Other operation expenses increased $52.0 million in 1987 due primarily to a full year of lease payments for PVNGS Unit 2. Other operation expenses increased $69.5 million in 1986 due primarily to lease payments of $39.6 million and other operation expenses of $9.9 million associated with PVNGS Units 1 and 2. Other operation expenses associated with PVNGS units will increase further due to the addition of PVNGS Unit 3 in 1988.

Operating income taxes increased $21.7 million in 1987 after having declined $28.6 million in 1986. These changes are due primarily to the effects of certain tax benefits associated with start-up activities at PVNGS, losses on hedging transactions, and premiums incurred in the retirement of certain first mortgage bonds. These tax benefits increased net earnings by $12.3 million and $41.6 million in 1987 and 1986, respectively.

AFUDC, a non-cash item, decreased $14.5 million in 1987 and $32.0 million in 1986. Both decreases are a result of lower average construction work in progress balances resulting largely from the commercial operation of PVNGS Units 1 and 2 in 1986. AFUDC will decline further in 1988 due to the commercial operation of PVNGS Unit 3 in January 1988. This low level of AFUDC will continue into the 1990s, reflecting the planned reduction in utility construction spending.

Equity in earnings of unconsolidated affiliates declined $.6 million in 1987 and declined $7.4 million in 1986. The 1987 decline resulted primarily from a continued downturn in real estate operations resulting from depressed market conditions in Texas and Oklahoma. The decline in 1986 was due mainly to a write-off of a venture capital investment and to a decline in earnings from real estate operations.

Other income decreased $5.6 million in 1987 after having increased $10.1 million in 1986. The current year decline is due primarily to reduced interest income of a subsidiary, which resulted from the prepayment of a $39 million note by an unconsolidated affiliate in late 1986. Other income had increased in 1986 largely as a result of increased earnings from the investment of proceeds from the sale and leaseback transactions of the Company's interests in PVNGS Units 1 and 2.

Interest charges on long-term debt and preferred dividends declined $20.4 million and $6.3 million, respectively, in 1987 after having declined $24.0 million and $5.7 million, respectively, in 1986. These decreases are due largely to the retirement of first mortgage bonds and preferred stock in 1986.

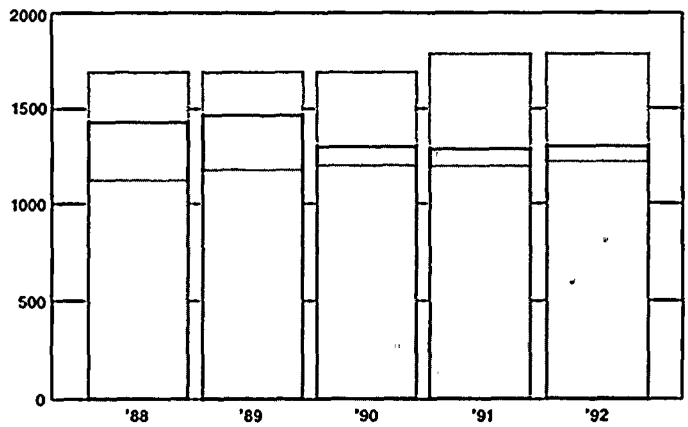
Restructuring Proposals; A Response to Issues Facing the Company

The Wholesale Power Market

Abundant electric generating capacity coupled with a soft wholesale power market continues to be the Company's major concern. The Company expects to have varying amounts of capacity and associated energy which will not be required to meet system demands or reserve margins during the next decade. The Company estimates that it will have an average of approximately 550 MW of such capacity at the time of summer peak for the years 1988 through 1992. Since this capacity is not in the Company's ratebase, off-system sales from this capacity are of vital importance. However, no significant new off-system sales were achieved in 1987 and only approximately 34 percent of this capacity for the 1988 to 1992 period is currently contracted for sale to other utilities. The Company's ability to market its remaining uncommitted capacity will be under extreme pressure. This ability is affected by transmission availability and levels of competition in the off-system market. Competition in this market has been intense due to the availability of surplus capacity from other utilities, low oil and natural gas prices and the emergence of co-generation and self-generation as competing energy sources.

The Company's earnings and cash generation will be particularly affected by the challenge of marketing substantial amounts of uncommitted capacity under current unfavorable market conditions. The Company's operation expenses have increased significantly in recent years with

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



☐ Forecasted Uncontracted Capacity†
☐ Contracted to Other Utilities
☐ Forecasted System Load, Including Required Reserves*

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

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

the addition of interests in PVNGS Units 1 and 2 to its generation plant and will increase further with the commercial operation of Unit 3, achieved in January 1988. Currently, levels of and prices for off-system sales are insufficient to cover the fixed costs of PVNGS generation. The Company anticipates the regional wholesale power market to improve in the mid- to late-1990s.

The Retail Electric Market

Consumer resistance to high electric prices is not limited to wholesale customers. Kirtland Air Force Base, the Company's largest retail customer, representing 4 percent of 1987 electric revenues, continues to receive service without a contract while seeking alternative suppliers. In addition, the Company's electric service franchise with the City of Albuquerque, representing 48 percent of the Company's 1987 electric revenues, expires in 1992. The City of Albuquerque is studying alternatives to a new franchise with the Company, including alternative suppliers to service the franchise area after expiration of the Company's current franchise. The Company is working with the City to resolve issues relating to the franchise renewal. The Company believes that power supply alternatives, other than those associated with the Company under its franchise, are not feasible.

Other Regulatory Matters

Since 1982, substantially all of the Company's uncommitted capacity has been treated as inventoried capacity under an NMPSC-approved inventorying methodology. Under the inventorying methodology, the Company has deferred and recorded as income a portion of the carrying cost of this uncommitted capacity. In 1987, this deferral provided income of $13.1 million—13.7 percent of the Company's consolidated net earnings. As of December 31, 1987, the Company has deferred $37.9 million of carrying costs under the inventorying methodology. However, Statement of Financial Accounting Standards No. 92 (SFAS No. 92), issued in August 1987, would require the discontinuance of deferrals under the inventorying methodology and the write-off of deferred carrying costs unless the Company obtains NMPSC approval of an alternative, meeting the requirements of SFAS No. 92.

As reported previously, the NMPSC initiated an investigation of PVNGS costs. If any costs associated with PVNGS are determined to be imprudent and are disallowed, the Company would be required to charge those costs to expense at the time such disallowance is determined to be probable. Management, however, believes that PVNGS was managed and constructed in a prudent manner.

Restructuring Proposals

The Company has considered various responses to its uncommitted capacity problem including a traditional rate case to seek recovery of its investment in PVNGS, an alternative phase-in plan which would meet the requirements of SFAS No. 92 and a restructuring proposal. The Company believes its restructuring proposal to be the most logical alternative to respond to these issues.

On August 14, 1987, the Company filed with the NMPSC an application for the Company's corporate reorganization as approved by the Company's shareholders in 1986, and for an additional restructuring. The proposal would include the formation of a holding company and the separation of the Company's electric utility operations into a generation entity regulated by the Federal Energy Regulatory Commission (FERC) and a distribution entity regulated by the NMPSC. Under this arrangement, the generation entity would be committed to supplying most of the projected power needs of the distribution entity through the 1990s under a 27 year power supply agreement.

The NMPSC staff responded to the Company's application for restructuring with an alternative restructuring plan. The NMPSC staff plan would allow the formation of a holding company and the phase-in of a portion of San Juan plant currently being inventoried, but would retain NMPSC jurisdiction over generation and transmission assets required to meet the needs of NMPSC jurisdictional customers. The plan would provide that the PVNGS assets, associated leases, and 130 MW of San Juan Unit 4 would be permanently excluded from NMPSC jurisdicitional ratebase and the Company would be allowed to sell such plant, or associated power or energy, without NMPSC approval.

The Company expects that a compromise between the two restructuring proposals will be the most likely outcome of its application. It is anticipated that such a compromise would resolve many of the issues facing the Company. The NMPSC review of PVNGS prudence would become moot. The SFAS No. 92 issue would be resolved as the Company would have a qualified phase-in plan for a portion of its uncommitted capacity and have the remaining assets representing uncommitted capacity excluded from NMPSC regulation. The problem of high retail rates would be addressed through the immediate reduction of rates and the creation of an economic development rate to stimulate load growth in the Company's service area. Certain accounting treatments allowed in regulatory accounting, however, would no longer be appropriate for the non-NMPSC regulated utility assets. This change would require an immediate write-off, which the Company had previously estimated at approximately $100 million under its restructuring plan. However, because of recent information from the FASB regarding accounting for non-regulated assets and uncertainties related to the ultimate form of a restructuring plan, a reasonable estimate of such write-off cannot be made at this time. While the write-off may be significant, it will not involve a cash expenditure. Under both proposed plans, a significant portion of the Company's generation assets would be removed from NMPSC regulation, which would better position the Company to compete in the highly competitive wholesale energy markets. Irrespective of any reorganization or restructuring, the Company's results of operations will depend primarily on existing conditions in the markets in which the Company competes.

Selected Financial Data

	1987	1986	1985	1984	1983
	(In thousands except per share amounts and ratios)				
Total Operating Revenues*	$ 689,656	$ 697,995	$ 689,982	$ 445,328	$ 397,474
Net Earnings	$ 95,389	$ 151,005	$ 146,310	$ 132,840	$ 140,519
Earnings per Common Share	$ 2.00	$ 3.29	$ 3.30	$ 3.11	$ 3.53
Total Assets	$2,815,298	$2,756,144	$3,010,238	$2,598,744	$2,486,429
Preferred Stock with Mandatory Redemption Requirements	$ 60,513	$ 66,147	$ 119,080	$ 121,080	$ 123,700
Long-Term Debt, less Current Maturities	$ 890,820	$ 901,511	$1,143,355	$1,030,557	$ 974,290
Common Stock Data:					
Dividends paid per common share	$ 2.92	$ 2.92	$ 2.89	$ 2.85	$ 2.81
Dividend pay-out ratio	146.0%	88.8%	87.6%	91.7%	79.6%
Market price per common share at year end	$ 18.75	$ 33.00	$ 29.50	$ 24.375	$ 25.375
Book value per common share at year end	$ 25.68	$ 26.51	$ 25.73	$ 25.28	$ 25.20
Average number of common shares outstanding	41,647	40,401	37,059	35,011	32,956
Return on Average Common Equity	7.7%	12.8%	13.2%	12.5%	14.3%
Ratio of Earnings to Fixed Charges (S.E.C. Method)	1.51	2.51	2.63	2.32	2.81
Capitalization:					
Common stock equity	51.5%	51.6%	41.7%	42.1%	41.5%
Preferred stock:					
Without mandatory redemption requirements	2.8	2.8	4.5	4.9	5.2
With mandatory redemption requirements	2.9	3.1	5.1	5.5	6.0
Long-term debt, less current maturities	42.8	42.5	48.7	47.5	47.3
	100.0%	100.0%	100.0%	100.0%	100.0%

*Reflects gas operating revenues since January 28, 1985, the acquisition date of the gas operations.

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, by 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 Main & 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 and the consolidated statement of capitalization of Public Service Company of New Mexico and subsidiaries as of December 31, 1987 and 1986 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, 1987. 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, 1987 and 1986 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, 1987, in conformity with generally accepted accounting principles applied on a consistent basis.

PEAT MARWICK MAIN & CO.

Albuquerque, New Mexico
February 19, 1988

Consolidated Statement of Earnings

	Year Ended December 31 1987	1986	1985
	(In thousands except per share amounts)		
Operating Revenues:			
Electric	$468,049	$443,084	$408,101
Gas	210,634	244,666	273,737
Water	10,973	10,245	8,144
Total operating revenues	689,656	697,995	689,982
Operating Expenses:			
Fuel and purchased power	46,198	50,318	46,456
Gas purchased for resale	117,100	149,685	186,691
Other operation expenses	243,569	191,604	122,085
Maintenance and repairs	43,501	41,879	42,691
Depreciation and amortization	60,264	60,249	55,366
Taxes, other than income taxes	31,683	30,511	29,729
Income taxes (note 5)	14,990	(6,727)	21,850
Total operating expenses	557,305	517,519	504,868
Operating income	132,351	180,476	185,114
Other Income and Deductions, net of taxes (note 5):			
Allowance for equity funds used during construction	26,690	34,926	57,848
Deferred carrying costs on uncommitted electric generating capacity	13,069	16,191	3,230
Equity in earnings (loss) of unconsolidated affiliates	(2,194)	(1,567)	5,815
Other	(1,363)	4,193	(5,889)
Net other income and deductions	36,202	53,743	61,004
Income before interest charges	168,553	234,219	246,118
Interest Charges:			
Interest on long-term debt	67,573	87,961	111,974
Other interest charges	13,222	9,147	10,779
Allowance for borrowed funds used during construction	(7,631)	(13,894)	(22,945)
Net interest charges	73,164	83,214	99,808
Net Earnings	95,389	151,005	146,310
Preferred Stock Dividend Requirements	11,935	18,187	23,901
Net Earnings Applicable to Common Stock	$ 83,454	$132,818	$122,409
Average Number of Common Shares Outstanding	41,647	40,401	37,059
Earnings per Share of Common Stock	$ 2.00	$ 3.29	$ 3.30
Dividends Paid per Share of Common Stock	$ 2.92	$ 2.92	$ 2.89

Consolidated Statement of Retained Earnings

	Year Ended December 31 1987	1986	1985
	(In thousands)		
Balance at Beginning of Year	$213,416	$198,703	$182,964
Net Earnings	95,389	151,005	146,310
Dividends:			
Cumulative preferred stock	(11,935)	(18,187)	(23,901)
Common stock	(121,533)	(118,105)	(106,670)
Balance at End of Year	$175,337	$213,416	$198,703

See accompanying notes to consolidated financial statements.

Consolidated Balance Sheet

	December 31 1987	December 31 1986
	(In thousands)	
Assets		
Utility Plant, at Original Cost (notes 2, 7 and 11):		
Electric plant in service	$1,518,610	$1,499,548
Gas plant in service	338,842	327,188
Water plant in service	41,945	38,834
Common plant in service	42,226	44,820
Plant held for future use	33,103	74,132
	1,974,726	1,984,522
Less accumulated depreciation and amortization	510,002	463,470
	1,464,724	1,521,052
Construction work in progress	369,092	321,164
Nuclear fuel, net of accumulated amortization	58,738	60,763
Net utility plant	1,892,554	1,902,979
Other Property and Investments:		
Non-utility property, at cost, net of accumulated depreciation, partially pledged	221,948	166,609
Investment in unconsolidated affiliates	124,906	108,700
Other investments (note 3)	209,022	15,793
Total other property and investments	555,876	291,102
Current Assets:		
Cash	1,508	3,578
Temporary cash investments	22,417	255,857
Receivables, net	116,900	122,556
Fuel, materials and supplies, at average cost	68,805	58,326
Gas in underground storage, at last-in, first-out cost	11,496	12,037
Prepaid expenses	13,709	8,202
Total current assets	234,835	460,556
Deferred Charges	132,033	101,507
	$2,815,298	$2,756,144
Capitalization and Liabilities		
Capitalization (note 2):		
Common stock equity:		
Common stock outstanding—41,733,504 shares in 1987 and 41,313,358 shares in 1986	$ 208,668	$ 206,567
Additional paid-in capital	687,899	675,353
Retained earnings	175,337	213,416
Total common stock equity	1,071,904	1,095,336
Cumulative preferred stock without mandatory redemption requirements	59,000	59,000
Cumulative preferred stock with mandatory redemption requirements	60,513	66,147
Long-term debt, less current maturities	890,820	901,511
Total capitalization	2,082,237	2,121,994
Current Liabilities:		
Short-term debt (note 4)	184,000	32,622
Accounts payable	111,282	88,081
Current maturities of long-term debt	21,654	45,907
Accrued interest and taxes	9,071	29,646
Other current liabilities	35,533	39,774
Total current liabilities	361,540	236,030
Deferred Credits:		
Accumulated deferred investment tax credits (note 5)	150,175	184,888
Accumulated deferred income taxes (note 5)	131,534	123,751
Other deferred credits	89,812	89,481
Total deferred credits	371,521	398,120
Commitments and Contingencies (notes 7 through 12)		
	$2,815,298	$2,756,144

See accompanying notes to consolidated financial statements.

Consolidated Statement of Changes in Financial Position

	Year Ended December 31 1987	1986	1985
		(In thousands)	
Funds Generated Internally:			
Net earnings	$ 95,389	$151,005	$146,310
Charges (credits) to earnings not requiring funds:			
Depreciation and amortization	85,388	78,432	64,068
Provision for noncurrent deferred income taxes, net	7,783	3,279	5,614
Investment tax credits, net	(34,713)	38,432	44,651
Allowance for equity funds used during construction	(26,690)	(34,926)	(57,848)
Deferred carrying costs on uncommitted electric generating capacity	(13,069)	(16,191)	(3,230)
Earnings of unconsolidated affiliates	3,936	3,121	(11,545)
Funds derived from operations	118,024	223,152	188,020
Less cash dividends	133,468	136,292	130,571
Total funds generated internally	(15,444)	86,860	57,449
Funds Obtained from (Applied to) Outside Sources:			
Sale of common stock	14,619	103,676	47,975
Proceeds from pollution control revenue bonds	13,063	4,037	52,146
Reacquisition of preferred stock	—	(89,825)	—
Reacquisition of first mortgage bonds	(3,827)	(212,247)	—
Bond and preferred stock reacquisition premiums	(395)	(44,781)	—
Loss on hedging transactions	—	(17,597)	—
Increases in other long-term debt	50,739	141,529	145,696
Decreases in other long-term debt	(70,846)	(175,948)	(84,129)
Increase (decrease) in short-term debt, net	151,378	(16,813)	19,122
Proceeds from sale of utility plant, net	—	429,612	363,421
Decrease (increase) in working capital, other than short-term debt	199,853	11,522	(169,983)
Other	(9,757)	12,425	119
Total funds obtained from outside sources	344,827	145,590	374,367
Total funds generated	$329,383	$232,450	$431,816
Construction Expenditures, Investments and Acquisition:			
Utility plant additions	$ 93,411	$163,489	$203,347
Increase in other property and investments	235,972	68,961	15,227
Acquisition of noncurrent New Mexico gas properties	—	—	213,242
Total construction expenditures, investments and acquisition	$329,383	$232,450	$431,816

See accompanying notes to consolidated financial statements.

Consolidated Statement of Capitalization

				December 31 1987	December 31 1986
				(In thousands)	
Common Stock Equity (note 2):					
Common stock, par value $5 per share				$ 208,668	$ 206,567
Additional paid-in capital				687,899	675,353
Retained earnings				175,337	213,416
Total common stock equity				1,071,904	1,095,336
Cumulative Preferred Stock (note 2):					
	Stated Value	Shares Outstanding at December 31, 1987	Current Redemption Price		
Without mandatory redemption requirements:					
1965 Series, 4.58%	$100	130,000	$102.00	13,000	13,000
8.48% Series	100	200,000	103.00	20,000	20,000
8.80% Series	100	260,000	106.20	26,000	26,000
		590,000		59,000	59,000
With mandatory redemption requirements:					
8.75% Series	100	321,792	105.80	32,179	36,080
12.52% Series	50	613,340	—	30,667	35,000
14.75% Series	100	—	—	—	3,175
		935,132		62,846	74,255
Redeemable within one year		(46,660)		(2,333)	(8,108)
		888,472		60,513	66,147
Long-Term Debt (note 2):					
Issue and Final Maturity		**Interest Rates**			
First mortgage bonds:					
1987 through 1992		4⅜% to 4⅞%		16,465	16,936
1993 through 1997		5⅞% to 13⅛%		46,615	46,822
1998 through 2002		7¼% to 8⅛%		47,857	48,644
2003 through 2007		8⅛% to 10⅛%		95,646	95,896
2008 through 2013		9% to 13⅛%		64,113	69,380
1993 through 2013—pollution control series, securing pollution control revenue bonds		5.9% to 10¾%		437,045	437,045
Funds held by trustee				(5,548)	(5,163)
Total first mortgage bonds				702,193	709,560
Pollution control revenue bonds:					
2003 through 2013		10% to 10¼%		100,000	100,000
2009		variable rate		37,300	37,300
Funds held by trustee				—	(13,448)
Other, including unamortized premium and discount				72,981	114,006
Total long-term debt				912,474	947,418
Current maturities				(21,654)	(45,907)
Long-term debt, less current maturities				890,820	901,511
Total Capitalization				$2,082,237	$2,121,994

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements December 31, 1987, 1986 and 1985

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.

Principles of Consolidation
The consolidated financial statements include the accounts of Public Service Company of New Mexico and subsidiaries in which it owns a majority voting interest. 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:

	1987	1986	1985
Electric plant	3.14%	3.23%	3.26%
Gas plant	3.11%	3.15%	2.94%
Water plant	2.14%	2.03%	2.09%
Common plant	9.10%	9.46%	9.38%

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 noncash 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 to the extent allowed by regulatory agencies.

AFUDC is computed using the maximum rate, net of taxes, permitted by FERC. The rates used were 9.06 percent, 8.97 percent and 9.22 percent for 1987, 1986 and 1985, 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 would be recovered over the useful life of the generating facility at such time as the uncommitted capacity is needed to meet NMPSC jurisdictional load.

Through 1987, deferred carrying charges have totaled $127.5 million of which $75.3 million has been recovered from off-system energy sales, $4.3 million has been recovered in rates charged to retail customers and $10.0 million was recovered through the sales of portions of San Juan Unit 4, leaving $37.9 million in deferred charges to be recovered.

In August 1987, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 92, Regulated Enterprises—Accounting for Phase-in Plans, as an amendment to SFAS No. 71, Accounting for the Effects of Certain Types of Regulation. SFAS No. 92 requires the Company to obtain NMPSC approval of modifications or alternatives to the Company's inventorying methodology to allow the full recovery of deferred carrying costs within ten years from the date of such

NMPSC approval. If the Company does not obtain such NMPSC approval, it will be required to discontinue the deferral of carrying costs under the inventorying methodology and to write off amounts previously deferred. The Company is currently evaluating alternatives to the inventorying methodology. The decision to file for NMPSC approval of any such alternative is dependent on progress in the NMPSC's consideration of the pending restructuring application. See note 12.

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 power and 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 through tax normalization. See note 5. 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 primarily for certain capitalized start-up and pre-operational costs at the Palo Verde Nuclear Generating Station (PVNGS), premiums on retirement of first mortgage bonds, losses on hedging transactions, accelerated amortization of pollution control facilities and for minor differences between book and tax depreciation.

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.

In December 1987, the FASB issued SFAS No. 96, Accounting for Income Taxes, which prescribes a new accounting standard for income taxes. SFAS No. 96 retains the requirement that deferred income taxes be recorded to reflect tax normalization. Additionally, it requires that such deferrals be recorded using the liability method. Under this method, deferred tax liabilities are computed using the tax rates in effect when the temporary differences reverse. For regulated companies, any changes in tax rates applied to accumulated deferred income taxes may not be immediately recognized because of ratemaking and tax accounting provisions contained in the Tax Reform Act of 1986.

SFAS No. 96 is effective for fiscal years beginning after December 15, 1988 with earlier adoption permitted. The Company has not determined when it will adopt SFAS No. 96, but it is anticipated that such adoption will not have a material effect upon the Company's financial statements and operating results, regardless of when it occurs.

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 Capitalization

Common 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 2,217,655 shares remaining unissued at December 31, 1987. After April 1987, shares required by the Stock Plans (with the exception of the Consumer Stock Plan) were obtained from the open market.

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, 1987, there were no retained earnings restricted under such provisions.

Cumulative Preferred Stock

The number of authorized shares of cumulative preferred stock is 10,000,000 shares.

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 for the 12.52% Series may be made prior to October 15, 1991, except for the use of sinking fund and optional redemptions.

Mandatory redemption requirements for 1988 through 1992 are $2,333,000, $3,612,200, $3,633,000, $3,633,000 and $3,633,000, respectively.

In 1987 and 1986, the Company redeemed or purchased approximately $11.4 million and $93.8 million, respectively, of the Company's cumulative preferred stock.

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		Cumulative Preferred Stock — 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, 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 issuance 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	41,313,358	206,567	675,353	590,000	59,000	988,140	66,147
Stock Plans	420,146	2,101	12,518	—	—	—	—
Redemption of stock	—	—	28	—	—	(53,008)	(3,301)
Redeemable within one year	—	—	—	—	—	(46,660)	(2,333)
Balance at December 31, 1987	41,733,504	$208,668	$687,899	590,000	$ 59,000	888,472	$ 60,513

Long-Term Debt

Substantially all utility plant is pledged to secure the Company's 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 1992 on long-term debt outstanding at December 31, 1987, are as follows:

1988	$21,654
1989	$33,056
1990	$15,580
1991	$17,913
1992	$ 6,066

Long-term debt includes certain issues which, although current by their terms, can be refinanced by existing long-term credit arrangements.

3 Other Investments

Marketable equity securities are stated at the lower of aggregate cost or market. Other long-term investments are stated at cost.

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 $181.0 million and $3.0 million at December 31, 1987, and approximately $19.7 million and $12.9 million at December 31, 1986. At December 31, 1987, the Company had unused credit commitments from various banks totaling approximately $324.5 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:

	1987	1986	1985
		(In thousands)	
Current Federal income tax	$ 10,615	$ 57,012	$19,500
Current State income tax	(1,259)	23,869	12,633
Deferred Federal income tax	4,808	(8,985)	25,399
Deferred State income tax	3,095	(2,645)	2,804
Investment tax credit utilized and deferred	(3,329)	42,992	41,939
Amortization of accumulated investment tax credits	(5,367)	(5,176)	(3,332)
Total income taxes	$ 8,563	$107,067	$98,943
Charged (credited) to operating expenses	$ 14,990	$ (6,727)	$21,850
Charged (credited) to other income and deductions	(6,427)	113,794	77,093
Total income taxes	$ 8,563	$107,067	$98,943

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:

	1987	1986	1985
		(In thousands)	
Deferred fuel costs	$ 2,968	$ (3,074)	$ 3,504
Depreciation and cost recovery timing differences	10,514	18,800	23,822
Pension cost timing differences	2,765	(4,101)	—
Receipt of advance lease payments	828	(31,007)	—
Contributions in aid of construction	(4,903)	—	—
Unbilled revenues	(2,689)	—	—
Alternative minimum tax in excess of regular tax	(8,446)	—	—
Other	6,866	7,752	877
Total deferred taxes	$ 7,903	$(11,630)	$28,203

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:

	1987	1986	1985
Federal income tax statutory rate	40.0%	46.0%	46.0%
Allowance for funds used during construction	(13.2)	(8.7)	(15.2)
Deferred carrying costs on uncommitted electric generating capacity	(5.0)	(2.9)	(.6)
Investment tax credits	(5.2)	(2.0)	(1.5)
PVNGS start-up and pre-operational costs	(7.3)	(6.3)	(4.8)
Capital gains rate net of minimum tax	—	(6.1)	(3.8)
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	(1.1)	6.7	—
Premiums on retirement of first mortgage bonds	.2	(5.7)	—
Losses on hedging transactions	.2	(2.8)	—
State income tax	1.5	4.4	3.4
Other	(1.9)	(2.5)	(.7)
Company's effective tax rate	8.2%	41.5%	40.3%

The cumulative net amount of income tax timing differences upon which deferred income taxes have not been provided is estimated to be approximately $96.7 million and $66.6 million as of December 31, 1987 and 1986, 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.

Total pension cost was approximately $8.2 million in 1985. The components of net periodic pension cost and total pension cost (in thousands) for 1987 and 1986 include:

	1987	1986
Service cost	$ 6,598	$ 4,878
Interest cost	10,965	8,668
Actual return on plan assets	(10,432)	(12,163)
Other	(1,356)	872
Net periodic pension cost	5,775	2,255
Termination loss	—	10,640
Curtailment gain	—	(2,868)
Total pension cost	$ 5,775	$10,027

The following sets forth the plan's funded status and amounts recognized in the Company's Consolidated Balance Sheet at December 31, 1987 and 1986 (in thousands):

	1987	1986
Vested benefits	$ 68,656	$ 70,089
Non-vested benefits	6,174	7,790
Accumulated benefit obligation	74,830	77,879
Effect of future compensation levels	33,250	48,399
Projected benefit obligation	108,080	126,278
Fair value of plan assets	126,714	111,774
Assets over/(under) projected benefit obligations	$ 18,634	$(14,504)

The components of assets over/(under) projected benefit obligations (in thousands) are as follows:

	1987	1986
Net unrecognized gain/(loss) from past experience different from assumed	$ 8,597	$(21,931)
Unamortized asset at transition, being amortized over 16 years through year 2002	16,290	17,454
Accrued pension liability	(6,253)	(10,027)
	$18,634	$(14,504)

The weighted average discount rates used to measure the projected benefit obligation are 10.0 percent for 1987 and 8.5 percent for 1986; the weighted average discount rates used to measure the net periodic pension cost are 8.5 percent for 1987 and 9.75 percent for 1986; the rate of increase in future compensation levels based on age-related scales are 6.5 percent for 1987 and 6.2 percent for 1986; and the expected long-term rate of return on plan assets is 10.0 percent for both years.

7 Construction Program and Jointly-Owned Plants

The Company operates and jointly owns the steam turbo-electric San Juan Generating Station. At December 31, 1987, the Company owned an undivided 50 percent interest in the first three units of the San Juan Generating Station and 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. Commercial operation commenced January 28, 1986 for Unit 1, September 19, 1986 for Unit 2, and January 8, 1988 for Unit 3. 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. The Company received approximately $900.5 million from these sales.

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

It is estimated that the Company's utility construction expenditures for 1988 will approximate $104 million, including expenditures on the jointly-owned projects. In connection therewith, substantial commitments have been made.

At December 31, 1987, 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)	$803,602	$190,708	$ 6,603	51.6%
Palo Verde Nuclear Generating Station Unit 3 (Nuclear)*	$ 5,973	$ 237	$313,177	10.2%
Four Corners Generating Station Units 4 and 5 (Coal)	$ 89,297	$ 17,307	$ 11,595	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 payments under this contract amounted to $41.5 million, $39.2 million and $38.9 million for 1987, 1986 and 1985, respectively. The minimum payment for each of the next five years under this contract is approximately $27.0 million annually. Under a contract beginning in June 1991, the Company is also obligated to make minimum payments of approximately $6.6 million and approximately $11.4 million in 1991 and 1992, respectively.

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, 1987 and 1986 was approximately $3.9 million and $5.4 million, respectively.

Future minimum lease payments at December 31, 1987 are:

	Capital Leases	Operating Leases
	(In thousands)	
1988	$3,317	$ 99,365
1989	3,066	98,488
1990	1,153	97,502
1991	20	96,640
1992	14	96,067
Later years	13	2,082,600
Total minimum lease payments	7,583	$2,570,662
Less amount representing interest and executory costs	1,343	
Present value of net minimum lease payments	$6,240	

Operating lease expense was $102,625,000 in 1987, $59,104,000 in 1986 and $15,312,000 in 1985. As of December 31, 1987, the aggregate minimum payments to be received in future periods under noncancelable subleases are approximately $3,755,000.

10 Natural Gas Contract Disputes

The Company's Gas Company of New Mexico division (GCNM) and Sunterra Gas Gathering Company (Gathering Company), a subsidiary of the Company, are experiencing gas purchase contract disputes which are common in the gas industry. GCNM and Gathering Company are currently disputing claims by certain producers, relating to both contract pricing and take or pay obligations. Some of these disputes are the subject of pending litigation against GCNM and Gathering Company. The Company feels it has valid defenses which it intends to assert vigorously. Consistent with historic practices, the Company has sought and will continue to seek to recover from its customers, through various rate mechanisms, any amounts ultimately paid to producers. Therefore, the Company does not anticipate these claims will materially impact its financial condition or results of operations.

11 Palo Verde Nuclear Generating Station

As stated in note 7, the Company participates with six other utilities in the three units of PVNGS. In 1985 and 1986, the Company sold and leased back its entire undivided interest in PVNGS Units 1 and 2 and certain common facilities. PVNGS Units 1 and 2 were declared in commercial service in 1986 and Unit 3 was declared in commercial service on January 8, 1988. Under the Inventory of Capacity rate-making methodology, PVNGS is not currently in the Company's ratebase and is not expected to begin entering rate-base until the 1990s.

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. The scope of the investigation and the issues to be reviewed have not yet been determined. Management is unable to predict what findings the NMPSC will make as a result of the investigation. Management believes that PVNGS was managed and constructed in a prudent manner. See note 12.

The Federal Price-Anderson Act limits the public liability for claims that could arise from a nuclear incident to a maximum amount of $720 million, as of February 10, 1988. The PVNGS participants have purchased primary insurance for this exposure in the maximum available amount, presently $160 million, with the remaining $560 million being provided by secondary financial protection as required by the Price-Anderson Act and the Nuclear Regulatory Commission (NRC). Under the provisions of this secondary program, the PVNGS participants could be assessed up to $15,000,000 (the Company's 10.2 percent share of which would be $1,530,000) per nuclear incident involving any participating licensed reactor in the United States, subject to a maximum of $30,000,000 (the Company's 10.2 percent share of which would be $3,060,000) in any year in the event of more than one incident. Several bills are currently pending in Congress which would significantly increase the limit on public liability claims resulting from nuclear energy hazards and the Company's potential assessment under the secondary financial protection program. The ultimate response of Congress to any pending bills cannot be predicted, nor is it certain that Congress will amend the Price-Anderson Act in any respect. In addition to the liability coverage discussed above, the PVNGS participants maintain nuclear property damage and decontamination insurance in the approximate aggregate amount of $1.53 billion, as of February 10, 1988, as well as additional off-site property insurance.

Federal legislation imposes the responsibility for the disposal of spent nuclear fuel and other high level wastes upon the Federal government and directs the Secretary of the Department of Energy (DOE) to undertake a program for the development of a waste disposal facility for the receipt and disposal of spent nuclear fuel. PVNGS is designed to permit on-site storage of spent fuel discharged from normal operation of all three units beyond the year 2000. The participants entered into a contract with DOE in July 1984, which provides for the eventual disposal of all spent nuclear fuel expected to be generated by PVNGS during its useful life.

The Company's share of PVNGS decommissioning costs is presently estimated, in 1986 dollars, at approximately $63 million. The NMPSC has approved a plan for funding the Company's share of the costs of decommissioning PVNGS. The plan calls for annual deposits to the decommissioning trust in the current amount of $396,000 per unit, subject to adjustment for changes in estimated decommissioning costs and/or trust fund earnings. The trust funds will be invested under a plan which allows the Company to accumulate funds for decommissioning on a tax-deferred basis. The Company began funding its share of decommissioning costs for PVNGS Units 1 and 2 in 1987.

12 Reorganization and Restructuring

On August 14, 1987, the Company filed with the NMPSC an application for a corporate reorganization and restructuring. The Company's proposal includes the formation of a holding company and separation of the Company's electric operations into a generation entity regulated by the FERC and a distribution entity, a limited partnership, regulated by the NMPSC. Under this arrangement, the generation entity would be committed to supply most of the projected power needs of the distribution entity through the 1990s under a 27 year power supply agreement. In January 1988, the NMPSC staff proposed an alternative to the Company's plan. The NMPSC staff's proposal would allow the formation of a holding company but would not include a separate distribution entity. Under the staff's proposal, all distribution, transmission and generating facilities which serve New Mexico customers would remain in one NMPSC-regulated company. Certain generating plant would be phased into NMPSC jurisdictional ratebase over 10 years. Other generation plant, including PVNGS, in excess of NMPSC jurisdictonal needs would be permanently excluded from ratebase and the Company would be allowed to sell such plant, or associated power or energy, without NMPSC approval. The Company believes it will recover its investment in generation assets excluded from NMPSC regulation.

Under both proposed plans, the inventory of capacity rate-making methodology would no longer be appropriate and the prudency review of PVNGS costs by the NMPSC would become moot, since the PVNGS assets would not be regulated by the NMPSC. Certain accounting treatments allowed under regulatory accounting principles would no longer be appropriate for the Company's non-NMPSC regulated utility assets. This change would require an immediate write-off, which the Company had previously estimated at approximately $100 million under its restructuring plan. However, because of recent information from the FASB regarding accounting for non-regulated assets and uncertainties related to the ultimate form of a restructuring plan, a reasonable estimate of such write-off cannot be made at this time. While the write-off may be significant, it will not involve a cash expenditure.

The NMPSC has set October 3, 1988 as the beginning date of the hearing process, provided that parties to the case cannot reach an earlier agreement.

13 Segment Information

The financial information pertaining to the Company's electric, gas and other operations for the years ended December 31, 1987, 1986 and 1985 are as follows:

	Electric	Gas	Other	Total
		(In thousands)		
1987				
Operating revenues	$ 468,049	$210,634	$ 10,973	$ 689,656
Operating expenses excluding income taxes	341,635	195,329	5,351	542,315
Pre-tax operating income	126,414	15,305	5,622	147,341
Operating income tax	12,703	463	1,824	14,990
Operating income	$ 113,711	$ 14,842	$ 3,798	$ 132,351
Depreciation and amortization expense	$ 49,982	$ 9,313	$ 969	$ 60,264
Utility construction expenditures	$ 102,548	$ 17,125	$ 2,290	$ 121,963
Identifiable assets:				
Net utility plant	$1,623,751	$233,331	$ 35,472	$1,892,554
Other	475,416	90,301	357,027	922,744
Total assets	$2,099,167	$323,632	$392,499	$2,815,298
1986				
Operating revenues	$ 443,084	$244,666	$ 10,245	$ 697,995
Operating expenses excluding income taxes	295,799	223,205	5,242	524,246
Pre-tax operating income	147,285	21,461	5,003	173,749
Operating income tax	(8,224)	(606)	2,103	(6,727)
Operating income	$ 155,509	$ 22,067	$ 2,900	$ 180,476
Depreciation and amortization expense	$ 50,567	$ 8,916	$ 766	$ 60,249
Utility construction expenditures	$ 178,230	$ 19,689	$ 2,112	$ 200,031
Identifiable assets:				
Net utility plant	$1,643,227	$226,430	$ 33,322	$1,902,979
Other	427,598	78,260	347,307	853,165
Total assets	$2,070,825	$304,690	$380,629	$2,756,144
1985				
Operating revenues	$ 408,101	$273,737	$ 8,144	$ 689,982
Operating expenses excluding income taxes	227,228	250,899	4,891	483,018
Pre-tax operating income	180,873	22,838	3,253	206,964
Operating income tax	17,931	2,965	954	21,850
Operating income	$ 162,942	$ 19,873	$ 2,299	$ 185,114
Depreciation and amortization expense	$ 47,113	$ 7,515	$ 738	$ 55,366
Utility construction expenditures	$ 242,559	$ 17,675	$ 1,697	$ 261,931
Identifiable assets:				
Net utility plant	$1,923,939	$216,178	$ 31,340	$2,171,457
Other	460,514	92,352	285,915	838,781
Total assets	$2,384,453	$308,530	$317,255	$3,010,238

The Company has a contract to sell power to an unaffiliated utility company which accounted for approximately 10.4 percent of total 1987 revenues (including economy and other near-term energy transactions which are accounted for as a reduction of fuel and purchased power expense rather than as operating revenue). No customer accounted for more than 10 percent of total revenues for 1986 or 1985.

Comparative Operating Statistics

Comparative Operating Statistics	1987	1986	1985	1984	1983
Electric Service:					
Energy Sales—kWhr (in thousands):					
Residential	1,448,989	1,353,933	1,319,529	1,279,917	1,205,046
Commercial	2,003,735	1,872,902	1,765,077	1,706,044	1,600,199
Industrial	787,901	797,927	788,880	762,117	742,272
Other ultimate customers	207,173	208,534	206,356	184,725	185,824
Total sales to ultimate customers	4,447,798	4,233,296	4,079,842	3,932,803	3,733,341
Sales for resale	829,831	869,017	1,156,268	2,384,535	2,371,860
Other contracted energy sales*	1,661,095	1,625,217	2,200,952	885,116	778,311
Total kWhr sales	6,938,724	6,727,530	7,437,062	7,202,454	6,883,512
Electric Revenues (in thousands):					
Residential	$ 136,194	$ 126,053	$ 119,026	$ 107,395	$ 90,020
Commercial	179,653	166,424	152,921	134,532	107,729
Industrial	56,534	56,649	53,127	50,439	44,166
Other ultimate customers	15,161	14,622	14,293	11,950	10,913
Total revenues from ultimate customers	387,542	363,748	339,367	304,316	252,828
Sales for resale	72,159	71,412	60,421	131,013	136,273
Total revenues from energy sales	459,701	435,160	399,788	435,329	389,101
Miscellaneous electric revenues	8,348	7,924	8,313	3,645	2,846
Total electric revenues	$ 468,049	$ 443,084	$ 408,101	$ 438,974	$ 391,947
Customers at Year-End:					
Residential	244,427	237,759	227,420	217,614	208,368
Commercial	29,882	28,736	27,053	25,614	24,259
Industrial	399	414	428	436	438
Other ultimate customers	332	213	216	194	186
Total ultimate customers	275,040	267,122	255,117	243,858	233,251
Sales for resale	6	6	6	6	5
Total customers	275,046	267,128	255,123	243,864	233,256
Reliable Net Capability—kW	1,461,000	1,566,000	1,305,000	1,337,000	1,343,000
Coincidental Peak Demand—kW	916,000	916,000	861,000	976,000	998,000
Average Fuel Cost per Million BTU	$ 1.2894	$ 1.1710	$ 1.2233	$ 1.0970	$ 0.9957
BTU per kWhr of Net Generation	11,526	11,608	11,214	11,023	11,296
Water Service:					
Water Sales—Gallons (in thousands)	2,683,961	2,535,656	2,387,468	2,392,085	2,315,980
Revenues (in thousands)	$ 10,973	$ 10,245	$ 8,144	$ 6,354	$ 5,527
Customers at Year-End	19,448	18,820	18,240	17,717	16,721

*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 $95.6 million, $77.8 million, $86.0 million, $22.9 million, and $20.8 million in 1987, 1986, 1985, 1984 and 1983, respectively.

Comparative Operating Statistics

	1987	1986	1985*
Gas Service:			
Gas Deliveries—Decatherms (in thousands):			
Residential	24,510	22,076	19,232
Commercial	11,359	10,745	9,642
Industrial	2,196	5,909	13,806
Public authorities	6,811	8,323	9,073
Brokerage	2,796	2,079	13
Irrigation	1,402	1,853	1,693
Sales for resale	1,211	1,535	1,702
Total gas sales	50,285	52,520	55,161
Transportation deliveries	5,149	2,245	147
Total gas deliveries	55,434	54,765	55,308
Gas Revenues (in thousands):			
Residential	$114,164	$117,011	$111,427
Commercial	42,120	45,812	45,519
Industrial	8,102	23,139	48,933
Public authorities	22,729	30,213	38,181
Brokerage	5,213	3,759	31
Irrigation	3,781	6,142	6,507
Sales for resale	3,819	5,675	6,638
Total revenues from gas sales	199,928	231,751	257,236
Transportation	4,315	2,207	83
Miscellaneous gas revenues	6,391	10,708	16,418
Total gas revenues	$210,634	$244,666	$273,737
Customers at Year-End:			
Residential	297,204	290,175	283,530
Commercial	28,661	28,218	27,435
Industrial	118	145	170
Public authorities	2,425	2,444	2,427
Brokerage	2	14	1
Irrigation	1,257	1,328	1,432
Sales for resale	5	11	10
Transportation	16	16	4
Total customers	329,688	322,351	315,009

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

Quarterly Operating Results

The unaudited operating results (in thousands except per share amounts) by quarters for 1987 and 1986 are as follows:

Quarter Ended	Operating Revenues	Operating Income	Net Earnings	Earnings per Share
1987				
December 31	$157,211	$26,585	$18,547	$ .37
September 30	159,779	35,216	26,219	.56
June 30	166,185	30,973	21,472	.44
March 31	206,481	39,577	29,151	.63
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

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 1987 and 1986, by quarters, are as follows:

Quarter Ended	Range of Sales Prices High	Low	Dividends per Share
1987			
December 31	24⅞	17⅜	$0.73
September 30	33⅛	24	0.73
June 30	36⅝	30⅝	0.73
March 31	39¼	33⅛	0.73
Fiscal Year	39¼	17⅜	$2.92
1986			
December 31	36¾	33	$0.73
September 30	37⅞	32½	0.73
June 30	37⅛	30½	0.73
March 31	35⅞	28	0.73
Fiscal Year	37⅞	28	$2.92

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 1987 and 1986.

Stockholder Information

Annual Meeting of Stockholders—April 26, 1988

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 April 26, 1988 at 9:30 a.m. Mountain Daylight Time. Stockholders are urged to attend; however, whether or not they attend, proxies should be marked, signed, dated and returned promptly.

About Your Securities and Records

The common stock of Public Service Company of New Mexico is listed on the New York Stock Exchange and is also traded on the Pacific and Philadelphia Stock Exchanges. A consolidated quote is published in numerous daily stock tables carried by many newspapers. The ticker symbol for the common stock is PNM. The most common newspaper symbol is PSvNM.

PNM and Harris Trust Company act as transfer agents for PNM common stock. PNM acts as transfer agent for PNM preferred stock. PNM maintains all stockholder records of the corporation. First National Bank in Albuquerque and Harris Trust Company act as registrar agents for common and preferred stock.

Stockholder Information

Stockholders may obtain information relating to their share position, dividends, transfer requirements, lost certificates, dividend reinvestment accounts and other related matters by telephoning PNM Stockholder Services (numbers given below). Stockholders must provide their tax identification number, the name(s) in which their shares are registered and their record address when they request information. This service is available to all stockholders Monday through Friday 7:30 a.m. to 5:00 p.m. Mountain Time Zone. Stockholders also may obtain this information by writing to Stockholder Services, PNM, Alvarado Square—MS-0082, Albuquerque, NM 87158.

Duplicate Mailings

To reduce the overall volume of mailings, the Company makes it a practice to combine the mailing of financial information with other stockholder mailings, such as dividend checks and proxies. If a single household owns stock under several accounts, each account will be sent an individual mailing containing a check or proxy with the financial information. This results in some households receiving duplicate copies of the financial material.

When the Company does not combine a mailing with a check or proxy, the duplicate mailings can be prevented if the stockholder has notified the Company in writing to mail only one copy to a specific address.

Lost Checks and Certificates

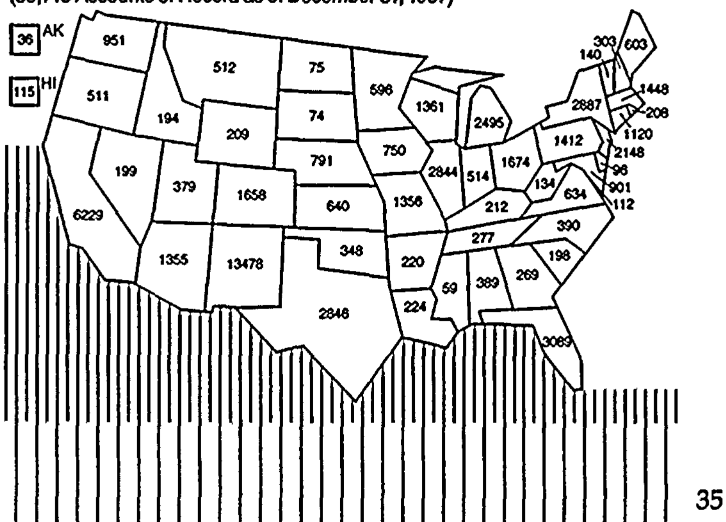
Dividend checks are often delayed or lost when a stockholder moves and does not notify the Company. It is easy to make an address change either by writing or by calling Stockholder Services.

Kathryn Kaiser, Stockholder Records Coordinator of the Stock Transfer Department, "I work with computers to figure your dividend. The department manages a databank of over 59,000 shareholders. There's a lot of paperwork involved in keeping track of each account, so if something we've sent to you could be clearer, please let me know. It's a rewarding job," says Kaiser, "PNM is a company that cares about its employees."

A written notification of nonreceipt of a dividend check is required before a replacement check will be issued.

Stock certificates are valuable pieces of paper that should be kept in a safe place. Lost certificates may be replaced only after issuance of an indemnity bond, for which a current premium of about two percent of the market value of the stock is

Geographic Distribution of PNM Stockholders
(59,713 Accounts of Record as of December 31, 1987)



charged by an insurance company. Immediately upon the disappearance or destruction of a certificate, stockholders should contact Stockholder Services who will provide information on the appropriate steps required to replace the certificate.

Dividend Payments Set by Board

The Company does not have fixed dates for payment of its common stock dividends. The dividend amount, record date and payment date are determined by the Board generally at meetings held on the fourth Tuesday of January, April, July, and October. It has been the practice in the past to set the payment date 31 days after these meetings.

Dividend Reinvestment and Stock Purchase Plan

Participants in this plan may choose to have all or part of their dividends automatically reinvested, make cash payments or do both in purchasing shares of PNM common stock. Participants receive account statements following each purchase and an annualized statement at the end of each year. These statements include the cost basis for shares purchased and should be kept for future income tax purposes. Participation in the plan is offered only by means of a prospectus. Prospectuses and authorization forms may be obtained by contacting the DRP office (numbers given at right).

Tax Reports on Dividend Income

PNM is required to report to the Internal Revenue Service the total amount of stockholder dividends paid to each stockholder during the preceding year. Form 1099 or 1042, which contain the information supplied by PNM to the IRS for each stockholder account, is mailed in January to all stockholders.

The Internal Revenue Service may require PNM to begin 20% backup withholding from dividends of stockholders who fail to provide a Taxpayer Identification Number (TIN), or provide an incorrect number, or when the IRS has notified PNM that a stockholder has underreported income. You may verify the TIN we have on record for your account by looking at your check stub if you receive cash dividends or your dividend reinvestment statement if you reinvest your dividends. If the TIN is incorrect you can notify the Stockholder Records Department and a Form W-9 will be sent to you.

Inquiries—Additional Information Available to Stockholders

Questions concerning stockholder transactions and the Dividend Reinvestment and Stock Purchase Plan should be directed to Stockholder Services, PNM, Alvarado Square, MS-0082, Albuquerque, NM 87158.
TELEPHONE NUMBERS:
(505) 848-2122 (local)
1-800-432-4494 (New Mexico)
1-800-545-4425 (outside New Mexico)

Questions about activities of the company and operating results should be directed to Director of Investor Relations, PNM, Alvarado Square, MS-0260, Albuquerque, NM 87158; or call (505) 848-2133.

Form 10-K Statement Available

Stockholders may obtain copies of the corporation's Form 10-K annual report to the Securities and Exchange Commission by writing to: J. B. Mulcock, Jr., Secretary, Public Service Company of New Mexico, Alvarado Square, Albuquerque, NM 87158

BOARD OF DIRECTORS: Front Row: Robert B. Rountree, Arturo G. Ortega, Jerry D. Geist, E. R. Wood, Ashton B. Collins, Jr.
Back Row: Claude E. Leyendecker, Hickum L. Galles, Jr., John P. Bundrant, Robert R. Rehder, Russell H. Stephens

Directors and Officers

Board of Directors

John P. Bundrant**
Director since 1983, age 55
President and Chief Operating Officer
Electric Operations
Public Service Company of New Mexico

Ashton B. Collins, Jr.
Director since 1979, age 55
President & Chief Executive Officer
Reddy Communications, Inc.,
a management consulting and services firm
Albuquerque, NM

Jerry D. Geist*†
Director since 1974, age 53
Chairman and President
Public Service Company of New Mexico

Claude E. Leyendecker*
Director since 1970, age 65
Chairman of the Board
United New Mexico Bank at Mimbres Valley
Deming, NM

Arturo G. Ortega*
Director since 1985, age 67
Attorney, senior member of law firm of Ortega and Snead, P.A.
Albuquerque, NM

Robert R. Rehder*
Director since 1975, age 57
Professor of Management
The Robert O. Anderson Graduate Schools of Management
University of New Mexico
Albuquerque, NM

Robert B. Rountree*†
Director since 1983, age 63
Chairman of the boards of Sunbelt Mining Company, Inc. and Meadows Resources, Inc.

Russell H. Stephens*
Director since 1970, age 73
Retired Realtor
Rociada, NM

E. R. Wood*†
Director since 1968, age 76
Private Investor
Santa Fe, NM

Hickum L. Galles, Jr.
Director Emeritus
Director since 1969, age 75
Chairman of the Board
Galles Chevrolet Company
Albuquerque, NM

PNM Corporate

Jerry D. Geist
(27), age 53
Chairman and President

James B. Mulcock, Jr.†
(15), age 48
Senior Vice President, Corporate Affairs and Secretary

Albert J. Robison†
(19), age 47
Senior Vice President and Chief Financial Officer

Billy D. Lackey
(14), age 51
Vice President and Corporate Controller

Joellyn K. Murphy
(6), age 42
Vice President, Regulatory and Business Policy

Luther W. Reynolds, Jr.
(2), age 52
Vice President and Treasurer

PNM Electric

John P. Bundrant
(27), age 55
President and Chief Operating Officer, Electric Operations

William M. Eglinton
(17), age 39
Senior Vice President, Operations, Electric Operations

Jack L. Wilkins
(9), age 64
Senior Vice President, Power Supply, Electric Operations

William C. Wygant
(15), age 55
Senior Vice President, Administration, Electric Operations

Jeff E. Sterba
(10), age 32
Vice President, Revenue Management, Electric Operations

Gas Company of New Mexico

John T. Ackerman
(16), age 46
President and Chief Operating Officer, Gas Operations

D. A. "Zan" James
(2), age 44
Vice President, Marketing, Rates and Regulatory Affairs, Gas Operations

Theodore H. Morse
(25), age 51
Vice President, Engineering & Operations, Gas Operations

Henry O. Pocock
(10), age 44
Vice President, Human Resources and Administrative Support and Assistant Secretary, Gas Operations

M. Phyllis Bourque
(1), age 40
Vice President, Gas Supply, Gas Operations

PNM Subsidiaries

Meadows Resources, Inc.

Robert B. Rountree
(39), age 63
Chairman

James F. Jennings, Jr.†
(4), age 54
President and Chief Executive Officer

Max H. Maerki
(3), age 47
Senior Vice President

John H. von Rusten
(9), age 39
Vice President and Controller

Bruno E. Carrara
(17), age 38
Vice President and Secretary

Charles R. Mollo
(11), age 36
Vice President

Roger C. Rankin
(6), age 49
Vice President

Milo L. McGonagle
(1), age 57
Vice President

John W. Priesing†
Director since 1984, age 58
President
A. Johnson & Co., Inc.
New York, NY

Paragon Resources, Inc.

John P. Bundrant
(27), age 55
Chairman

Jack L. Wilkins
(9), age 64
President

Alfred C. Underwood
(20), age 61
Vice President

Sunbelt Mining Company, Inc.

Robert B. Rountree
(39), age 63
Chairman

Albert J. Robison
(19), age 47
President and Chief Operating Officer

Martin A. Clifton
(15), age 46
Vice President, Finance

Charles E. Hunter
(12), age 52
Vice President, San Juan Division

Terry D. Bauer
(9), age 39
Vice President, Corporate/Engineering Services

J. Douglas Ingram
(5), age 43
Vice President, Operations

Dennis E. Evans
(5), age 29
Vice President and Controller

*Member of Audit Committee
**Member of Executive Committee
†Member of Meadows Board of Directors

( ) Years of service with PNM or a PNM controlled affiliate.
Ages and years of service as of December 31, 1987.

Public Service Company of New Mexico
Alvarado Square
Albuquerque, New Mexico 87158
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