EL PASO ELECTRIC COMPANY
1987 ANNUAL REPORT

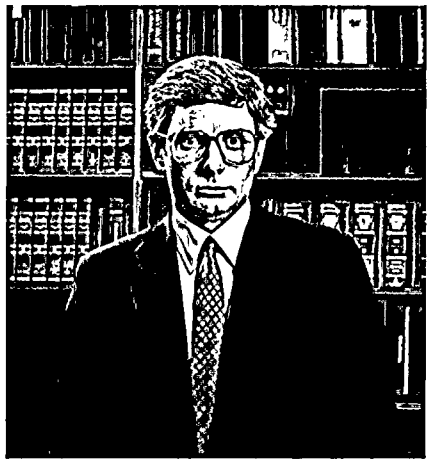
ANNUAL MEETING OF SHAREHOLDERS

All shareholders are invited to attend the Annual Meeting of Shareholders on Monday, May 16, 1988, at 10 a.m. El Paso time in the Westin Paso del Norte, 101 South El Paso Street in El Paso, Texas.

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

Photography by Vallarie & Arturo Enriquez, Vantage Point 1988

Evern R. Wall, Chairman of the Board and Chief Executive Officer



David H. Wiggs, Jr., President and Chief Operating Officer

DEAR SHAREHOLDER:

In 1987 El Paso Electric not only faced some of its greatest challenges, but also realized a number of important accomplishments and continued to capitalize on opportunities allowing it to provide for the needs of its shareholders, customers, and employees.

In the midst of recent turbulent and uncertain times, El Paso Electric has realized several objectives which will have positive, long-term effects on the financial condition of the Company. After two years of negotiations, a rate moderation plan was approved by the New Mexico Public Service Commission for our New Mexico customers. A stipulation, providing for a rate moderation settlement of the Company's investments in Units 1 and 2 at the Palo Verde Nuclear Generating Station, similar to the New Mexico plan, has been entered into by the Company and most of the parties to the pending Texas rate case. The Public Utility Commission of Texas (PUCT), is expected to issue its final order by mid to late March 1988.

Unit 3 of the Palo Verde Nuclear Generating Station progressed from the testing stage to commercial operation in record time. 1988 marks the beginning of full operations at Palo Verde, with all three units in commercial operation. In December 1987, the Company sold and leased back approximately 40 percent of our interest in Palo Verde Unit 3. Proceeds from the transaction will be used primarily to retire debt, allowing the Company to continue to redefine its capital structure.

The year was marked by the election of a new president of El Paso Electric. Effective January 1, 1988, the El Paso Electric board of directors elected David H. Wiggs, Jr., president and chief operating officer and a member of the board. Wiggs has served as the Company's chief regulatory attorney since 1976 and in that role has gained a great deal of knowledge of El Paso Electric and the electric utility industry as a whole. I will continue as the Company's chairman of the board and chief executive officer and will continue to oversee the activities of the entire corporation.

There was other positive news in 1987. El Paso Electric continued to experience significant increases in sales. Total kilowatt-hour sales in 1987 increased almost 13 percent over 1986. As in the past year, an increase in off-system kilowatt-hour sales was greatly responsible for the increase. Kilowatt-hour sales in the Company's service area increased 3.7 percent in 1987 compared with 1986 sales.

Although utility operating revenues increased approximately $19.7 million and utility

Ralph Morales, EPE computer operator, checks data cartridges

operating income increased approximately $6.6 million in 1987, earnings declined principally due to the $24.4 million after-tax non-cash write off that the Company recorded in September 1987 in connection with the stipulation on the Texas rate case mentioned above and the realized and unrealized losses, aggregating approximately $15.2 million after tax, that the Company sustained on its investments in marketable securities, primarily as a result of the stock market decline on October 19, 1987.

With respect to the losses on market investments, we have analyzed our investment portfolio and the reasons behind the losses and have taken steps that we believe will further protect our investments from future volatility in the market.

This letter was prepared and printed prior to the issuance of the PUCT's final order in the pending Texas rate case. Depending on the timing of the PUCT's issuance of its order, information concerning the final order, and its effect, if any, on El Paso Electric's financial position, may be provided in a supplement to this letter and in the Form 10-K included with this report.

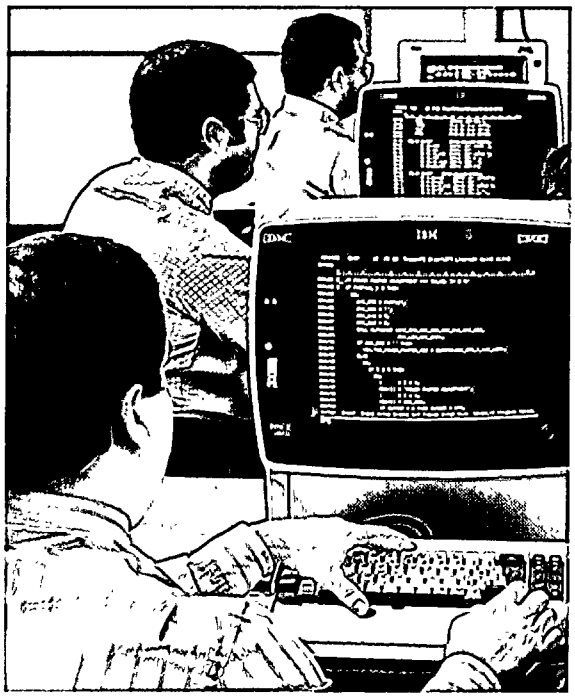
RATES AND REGULATION

New Mexico

The Company has been advocating the concept of electric rate moderation for several years. A viable rate moderation plan would gradually incorporate the effects of major plant additions into rates, provide customers with a moderated, predictable price for electricity while assuring long-term customer base revenue for the Company and its shareholders.

During March of 1987, a rate moderation agreement was reached between the Company, its major customers, various consumer groups, government officials and the New Mexico Public Service Commission staff. The New Mexico Commission issued its order adopting the New Mexico Rate Moderation Plan in May 1987.

The rate moderation plan and the Commission final order issued in November 1987 allowed the Company full inclusion of the costs of Palo Verde Unit 1 in rate base. It also allowed into rates the book break-even portion of the lease payments associated with Palo Verde Unit 2 which resulted from the sale and leaseback transactions completed in 1986. As part of the rate moderation settlement, the Company agreed



EPE employees at an I.B.M. training class

not to seek any costs associated with Palo Verde Unit 3 for inclusion into rate base in New Mexico. The Company will now have the option to sell this portion of Palo Verde power on the open market. The plan also settled all issues relating to the prudence of the Company's investment in Palo Verde and settled any possible issue of over-capacity through 1993.

Under the New Mexico order, rate increases are limited to 3 percent based on total rates in 1987, and 3 percent increases in base rates in 1988 and 1989. Base rates may remain frozen at the 1989 rate level increase until December 31, 1994. The rate path ordered by the Commission allows the Company moderated rate increases and the ability to defer expenses charged to earnings in the early years of the plan for collection in later years. New rates under the first phase of the plan were ordered effective November 1987.

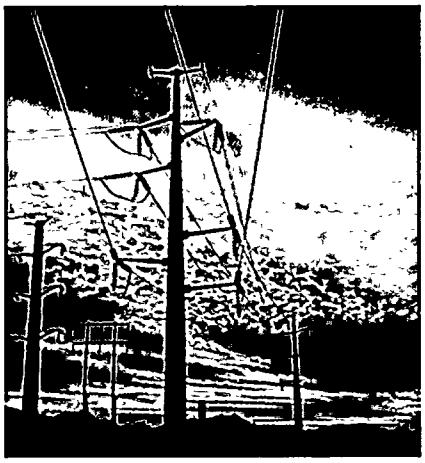
The Company has filed for a second increase in base rates of approximately $5.5 million, representing the second phase of the plan. New rates under this second phase are scheduled to be ordered in New Mexico in the fourth quarter of 1988.

Texas

In April 1987, the Company filed for an annual $77 million increase in Texas base rates. The filing was based on the inclusion of all the capital and deferred costs of Palo Verde Unit 1 and the inclusion of book break-even lease payments related to Unit 2.

On October 22, 1987, the Company entered into a settlement agreement providing for a rate moderation plan with most of the parties to the case. The parties to the agreement, which is not binding on the PUCT, includes the staff of the PUCT and certain intervenors and large industrial customers, but not the City of El Paso. The stipulated agreement, if ordered by the PUCT, provides for phased-in increases in Texas retail base rates of approximately $48 million and resolution of certain issues pertaining to the prudence of the Company's investment in Palo Verde. The agreement also requires a regulatory disallowance of a portion of the Company's investment in Palo Verde. As a result, the Company recorded, as a non-operating expense item in the third quarter of 1987, an after tax provision for an estimated regulatory disallowance of approximately $24.4 million.

On February 1, 1988, the administrative law judges and hearing examiner who conducted the hearings in the case issued their examiners' report and proposed final order. The report



Power lines near Sunset Substation

does not adopt the October 1987 stipulated settlement and does not include a rate moderation plan, but instead employs traditional rate-making methodology. The report recommended a $30.1 million, or approximately 21 percent, increase in Texas base rates. The examiners did not recommend any construction imprudence disallowance of the Company's investment in Palo Verde. However, the report did recommend that 25 percent of the Palo Verde Units 1 and 2 be excluded from rate base because of over-capacity.

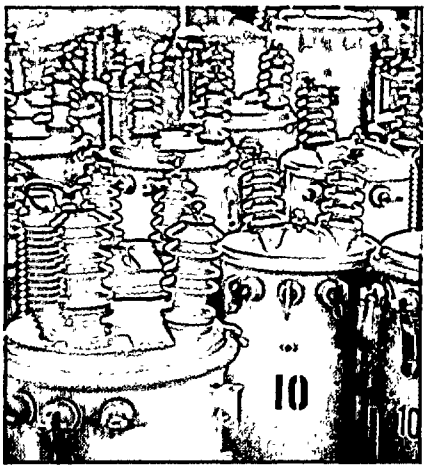
We believe that the recommendation in the report regarding over-capacity exclusions is inappropriate under the evidence in the case and is a misapplication of rate-making methodology. If the terms of the examiners' report were adopted by the PUCT, the Company would appeal the order to state district court.

The Company, and several intervenors who signed the stipulation, filed exceptions to the examiners' report, primarily emphasizing that the PUCT adopt the stipulated settlement. The PUCT is expected to issue its final order near the end of March. Depending on the PUCT's timing, information concerning the final order may be included in a supplementary statement to this letter and in the Form 10-K included with this annual report.

We believe that the stipulated settlement and the rate moderation plan contained therein provide an effective long-term resolution of the rate treatment of our investment in Palo Verde. Although there is no assurance that the PUCT will adopt the stipulated settlement, we remain optimistic that the PUCT will either adopt the stipulated settlement or some acceptable variation of the rate moderation plan provided therein.

Fuel Savings

With the addition of nuclear fuel to its fuel mix and the Company's efforts to acquire lower priced sources for its other fuels, El Paso Electric was able to return more than $20 million in fuel savings during 1987 to its customers in Texas and New Mexico.



Electric transformers

SALE AND LEASEBACK TRANSACTIONS

In 1987 El Paso Electric, its shareholders and its customers, began to realize some of the economic benefits of the 1986 sale and leaseback of all of its interest in Palo Verde Unit 2. The Company received approximately $684.4 million from the 1986 transactions. In December 1987 the Company sold and leased back approximately 40 percent of its interest in Unit 3 for approximately $250 million.

The Company is using the proceeds from the sale and leaseback transactions to retire short-term debt, make required preferred stock redemptions, retire long-term obligations and meet other cash requirements, including construction expenditures. Approximately $110 million of the proceeds are being used in connection with the Company's diversification program. The transactions have also helped mitigate rate increases associated with Units 1 and 2 and improved prospects for a viable rate moderation plan.

Additionally, the transactions have helped the Company return to more normal operations, after past rate reduction orders had forced a strict cash containment program. Although the sale and leaseback transactions have provided temporary relief from cash difficulties, the Company must continue to receive adequate and timely rate relief.

Palo Verde Nuclear Generating Station

PALO VERDE

Effective January 1988, all three units of the Palo Verde Nuclear Generating Station became fully operational, making it the largest nuclear power plant in the Western Hemisphere.

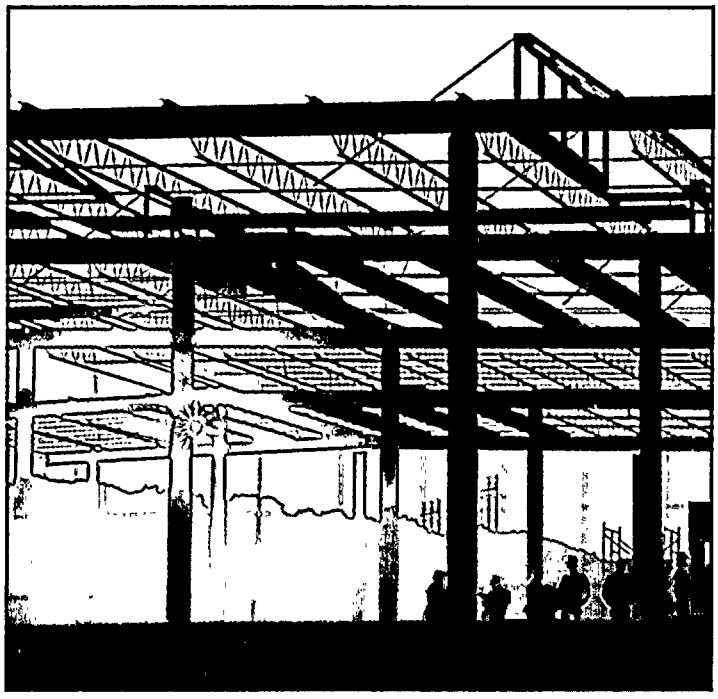
Arizona Nuclear Power Project employees completed the transition from construction to full operations of Palo Verde Unit 3 on January 11, 1988, completing a record breaking schedule. The unit received its operating license from the Nuclear Regulatory Commission March 26, 1987, allowing nuclear fuel to be loaded and low power testing to take place. Unit 3 achieved initial startup October 25, and, on November 25, the unit received its full-power license. On January 1, 1988, the unit achieved 100 percent power for the first time and six days later the systems check process was completed. The 43-day period between the granting of a full-power license and the completion of all testing required before the beginning of commercial operation set a record among all nuclear plants in the United States.

Recognition of the success at Palo Verde was exemplified through two prestigious awards in 1987 and 1988. On February 27, 1987, the Institute for the Advancement of Engineering (IAE) awarded Palo Verde the Engineering Project Achievement Award for 1987. The IAE represents approximately 50,000 engineers and scientists throughout the Southwest.

Additionally, national recognition was received January 27, 1988, with the announcement that the Palo Verde plant was designated for the Outstanding Engineering Achievement Award, the nation's highest engineering honor. The award is bestowed annually by the 75,000-member National Society of Professional Engineers.

The Palo Verde Nuclear Generating Station was formally dedicated as the "Energy Cornerstone of the Southwest" December 4, 1987. At the dedication ceremony, U.S. Secretary of Energy John Herrington commended Palo Verde as contributing significantly to the energy security of the U.S. by providing for the growing electrical needs of the entire Southwest while lessening the country's dependence on foreign oil.

The awards, speeches and other recognition notwithstanding, the most important aspect of Palo Verde is that it will provide a reliable and cost-competitive source of electric power well into the 21st century. El Paso Electric and the other Palo Verde participants have brought Palo Verde into commercial operation faster and at a lower cost per kilowatt than most of the nuclear plants placed in service in the country in this decade.



Construction site in El Paso

SUBSIDIARY ACTIVITIES

PasoTex Corporation

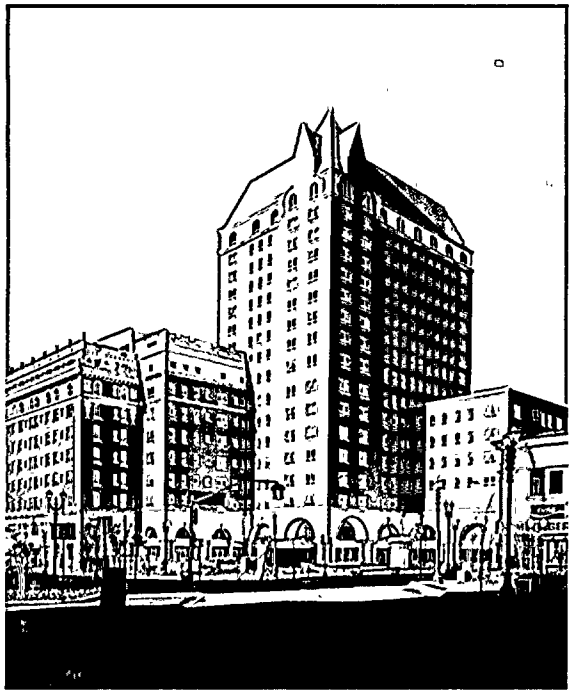
In November 1986, the El Paso Electric board of directors gave its final approval to the formation of a new subsidiary of the Company. The new subsidiary, PasoTex Corporation, is being funded with approximately $110 million from the gain realized from the Palo Verde Unit 2 sale and leaseback.

The El Paso Electric board of directors established several goals to be accomplished as a result of the creation of PasoTex. Primarily, PasoTex should earn a rate of return at least equal to El Paso Electric's authorized rate of return. Additionally, PasoTex is to bring industrial and commercial businesses into the El Paso/Las Cruces region, providing new jobs and economic development. Finally, the board is seeking to broaden El Paso Electric's customer base thereby spreading the fixed costs of providing electric service among a larger number of customers.

PasoTex has been highly successful in accomplishing a number of the goals established by the board. On July 1, PasoTex announced the acquisition of 50 percent equity ownership of common stock in Westwood Lighting Group, Inc., of Paterson, New Jersey. Westwood is one of the country's largest manufacturers and wholesalers of zinc cast brass plated lamps and the most vertically integrated operation in the lighting industry. All operations will be moved to the El Paso area, and it is expected that eventually Westwood will employ more than 500 people.

In December PasoTex announced the acquisition of the assets of B.P. John Furniture Company of Santa Ana, California, a national manufacturer and distributor of waterbed and conventional bedroom suites, dining room suites and occasional tables. A 300,000-square-foot manufacturing facility will be located in the area to house the new furniture company, which is expected to complete its move during the next two years. Approximately 500 jobs are expected to be created as a result of the move.

PasoTex has also acquired a majority ownership in Border Steel Rolling Mills presently located between El Paso and Las Cruces. Border Steel produces steel rebar and grinding balls from scrap metal, employs more than 600 people and is a major user of electricity. In 1987, PasoTex also completed the acquisition of Enerserv Products, Inc., of Houston, Texas, which end finishes and markets oil country tubular goods.



The Westin Paso del Norte

Franklin Land and Resources, Inc.

Franklin Land and Resources, Inc., continued to make important contributions to the El Paso community in 1987. The wholly owned subsidiary of El Paso Electric continued to demonstrate the exciting possibilities for downtown revitalization in El Paso, with its ownership of three fully restored downtown properties.

The Mills Building, which was restored and is owned by Franklin Land, is currently the corporate headquarters of El Paso Electric. The beautifully restored Cortez building is currently at the 89 percent occupancy level and will be completely occupied before the end of 1988. The Cortez Annex, which houses the downtown MeraBank Savings Bank and parking structure, is also completely occupied.

The Westin Paso del Norte hotel, after revitalization by Franklin, reopened its doors in 1986, has become the focal point for El Paso conventions, business meetings, major social events and other functions. Local convention and tourist officials confirm that largely because of the Westin, convention bookings in El Paso are up 60 percent. The Westin received national exposure on television during the 1987 Miss Teen U.S.A. pageant and the 1988 Miss U.S.A. pageant which were hosted by El Paso.

GROWTH IN ELECTRIC SALES

Sales for Resale

1987 was a very good year for electrical sales, especially sales to other utilities. Total sales increased from 4,491,304 megawatt-hours in 1986 to 5,079,754 megawatt-hours in 1987 or 13 percent. The Company continued to be successful in off-system sales despite a "soft" market for electricity.

In 1987 the Federal Energy Regulatory Commission (FERC) approved 15-year sales contracts between the Company and two of its utility customers, the Imperial Irrigation District (IID) and Texas-New Mexico Power Company (TNP). The Company and another utility customer, the Rio Grande Cooperative, have signed a 10-year energy sales agreement which is awaiting final approval of the FERC.

Sales to TNP and IID increased dramatically from 1986 to 1987. TNP increased its take from 196,797 megawatt-hours to 376,680 megawatt-hours in 1987, or about 91 percent. Sales to the IID increased from 400,070 megawatt-hours to 665,742 megawatt-hours, an increase of almost 66 percent.

Local Electric Sales

Sales in the Company's service territory also increased. On August 7, 1987, a record total system peak load of 975 megawatts was recorded, a 3.9 percent increase over the previous record. A new record native system peak load registering 820 megawatts, also occurred on August 7. The new native record was a 3.8 percent increase from the previous year.

Both the southern New Mexico and the El Paso region are continuing to experience steady growth. Kilowatt-hour sales in 1987 increased almost 6 percent in New Mexico over 1986 sales. In Texas, 1987 kilowatt-hour sales increased over 3 percent as compared with the previous year.

A COMMITMENT TO EXCELLENCE

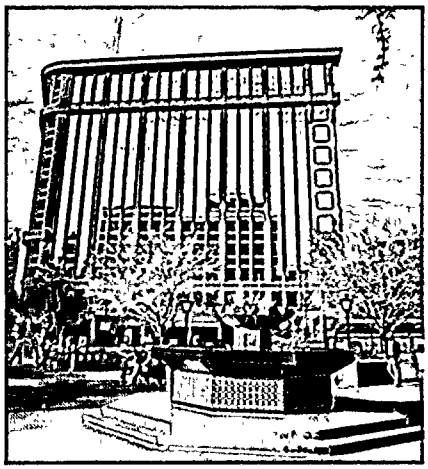
During 1987 a number of changes were made within the Company which are expected to provide for more efficient operations and improve service to customers. The Company's management has designated 1988 as the "Year of Superior Service," a year when the Company will be able to return to more normal operations and improve many customer service-related functions.

El Paso Electric, with the election of a new president, the announcement of many organizational changes and a recommitment to superior service to its customers, shareholders and employees, continues to look to the future. By successfully facing recent difficult times, El Paso Electric is a stronger company and is well prepared for the challenges and opportunities which lie ahead.

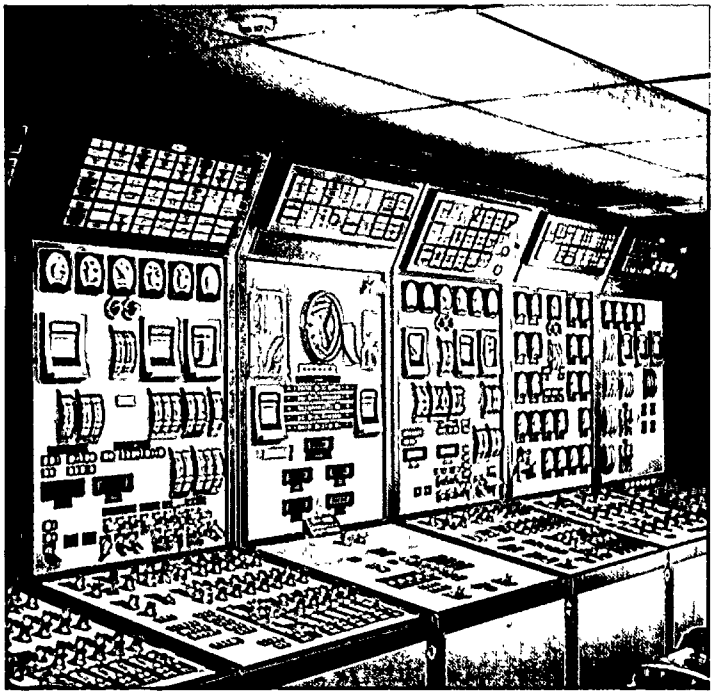
Sincerely,

Evern R. Wall
Chairman of the Board and
Chief Executive Officer

March 1, 1988



The Mills Building



Power station control room

CORPORATE INFORMATION.

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

DIVIDEND REINVESTMENT PLAN

In October 1987, the Company's management announced the implementation of a new automatic dividend reinvestment plan. The plan, which allows shareholders to reinvest their dividends to acquire additional shares of El Paso Electric common stock, became effective with the December 15, 1987, dividend payment.

SHAREHOLDER ORGANIZATION

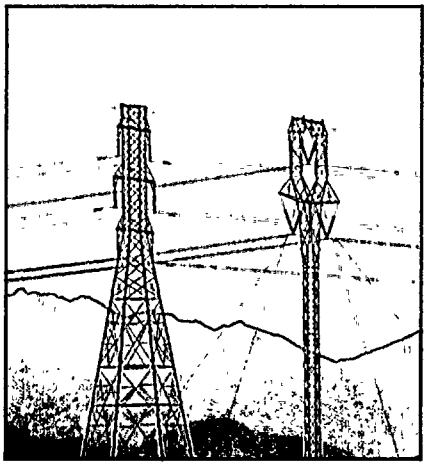
El Paso Electric shareholders are eligible to join a newly formed organization, Utility Shareholders of Texas, which has been chartered to represent Texas utility shareholders' interest before state and federal agencies and administrative bodies, to inform shareholders of issues affecting their investments and to help maintain good relations between its members and utility management. All persons who hold securities in a Texas utility are eligible for membership, regardless of whether or not they live in Texas. For more information contact Floyd R. Smith, 21 Cheska Drive, Beaumont, Texas 77706.

COMMON STOCK SHAREHOLDERS

The Common Stock of the Company is held in every state and the District of Columbia, some U.S. territories and many foreign countries. The number of shareholders on December 31, 1987, was 46,116. Our records indicate that about 55 percent of the Company's shareholders own less than 500 shares each.

TOLL-FREE TELEPHONE

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



Transmission lines near Palo Verde

TRANSFER AGENT

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

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

A complete copy of the Company's most recent Form 10-K report, filed with the Securities and Exchange Commission including Financial Statements and Financial Statement schedules set forth therein, will be made available to shareholders without charge upon written request to: Theta Fields, Secretary, El Paso Electric Company, Post Office Box 982, El Paso, Texas 79960.

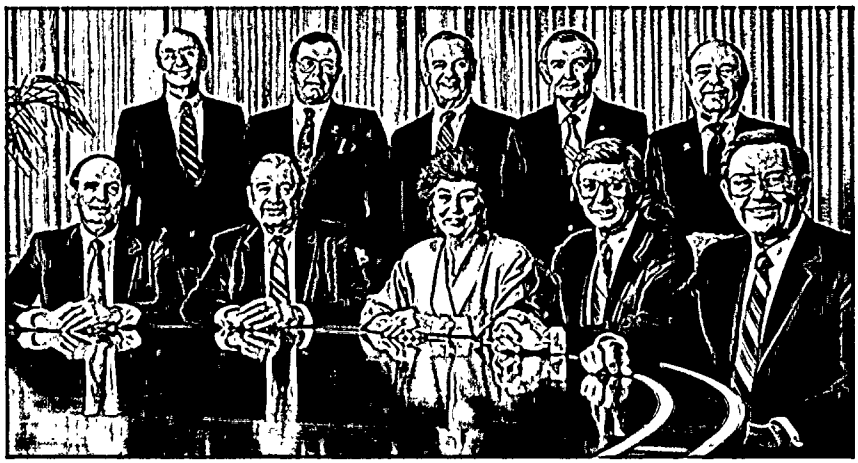
OFFICERS OF THE COMPANY

Evern R. Wall, Chairman of the Board and Chief Executive Officer (30)
David H. Wiggs, Jr., President and Chief Operating Officer
Charles Mais, Senior Vice President (33)
Ignacio R. Troncoso, Senior Vice President (18)
William J. Johnson, Senior Vice President and Chief Financial Officer (10)
William W. Royer, Senior Vice President (7)
Joseph E. Wasiak, Senior Vice President (10)
Lawrence M. Downum, Jr., Vice President (27)
James P. Maloney, Vice President (2)
Robert L. Corbin, Vice President (39)
Gary R. Hedrick, Treasurer (10)
Gordon M. Heggem, Controller (8)
Theta S. Fields, Secretary/Assistant to the Chairman (37)
Eduardo A. Rodriguez, General Counsel/Assistant Secretary (6)
George Clifford, Assistant Vice President (30)
Robert W. Waugh, Assistant Vice President (20)
Robert N. Hackett, Assistant Vice President (16)
J. Frank Bates, Assistant Vice President (14)
Cecelia R. Shea, Assistant Secretary (30)
C.R. Becker, Assistant Treasurer (10)

SUBSIDIARY OFFICERS

Robert R. Brown, President, Franklin Land and Resources, Inc. (8)
B.E. Bostic, President, PasoTex Corporation (40)

Years of Service ( )



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

DIRECTORS OF THE COMPANY

Evern R. Wall, Chairman of the Board and Chief Executive Officer (13)

David H. Wiggs, Jr., President and Chief Operating Officer

Wilfred E. Binns, Contractor, Binns Construction and Realty (5)

Robert H. Cutler, Chairman of the Board, Cutler Corporation (18)

H.M. Daugherty, Jr., Chairman of the Board and Chief Executive Officer, MBank El Paso N.A. (5)

Leonard A. Goodman, Jr., Chartered Life Underwriter/General Agent, John Hancock Financial Services (9)

Ben L. Ivey, Farming (18)

Josefina A. Salas-Porras, Secretary-Treasurer, Sunland Motor Sports, Inc. (9)

Tom C. Simpson, President, Simpson Farms, Inc.; President, Simpson Cattle and Feed Company (5)

Tad R. Smith, Vice Chairman of the Board, Attorney, Kemp, Smith, Duncan and Hammond; Counsel for the Company (27)

Years of Service ( )

MANAGEMENT CHANGES

The board announced several management changes in 1987 and 1988. David H. Wiggs, Jr., was elected president and chief operating officer and a director effective January 1, 1988. In December 1987, the board of directors elected four new senior vice presidents: William J. Johnson was elected senior vice president and chief financial officer; William W. Royer, senior vice president – Corporate Services Division; Ignacio R. Troncoso, senior vice president – Engineering, Transmission and Distribution Division; and Joseph E. Wasiak, senior vice president – Power Supply Division.

The board elected Gary R. Hedrick treasurer and Gordon M. Heggem controller. The board appointed Eduardo A. Rodriguez, general counsel; J. Frank Bates, assistant vice president – Customer Services Group; George Clifford, assistant vice president – special projects; and Robert W. Waugh, assistant vice president – Palo Verde Services.

The board has also elected B.E. Bostic, former executive vice president and chief financial officer, as president, PasoTex Corporation.

March 28, 1988

Texas Rate Case

Dear Shareholder:

We are pleased to announce that on March 22, 1988, the Public Utility Commission of Texas adopted, with certain modifications, the rate moderation plan that the Company and most of the parties to the Texas case had agreed to in an October 22, 1987 stipulated settlement of the case. We expect the Commission to issue its final order in the case, which will be based on the modified stipulation, by the end of this month. The plan approved by the Commission provides for a phased-in increase in our annual Texas retail base rates of approximately $46 million (60% of the increase requested by the Company). We will receive cash rate increases of approximately $21 million in the first twelve months of the rate moderation plan ($8.6 million net of fuel savings and miscellaneous revenues) and $7 million in each of the following three twelve-month periods. Base rates under the plan are expected to remain constant after the fourth rate increase through 1997. Revenue requirements above the allowed cash rate increases are deferred under the plan for recovery in later years, with all such deferrals scheduled for recovery within ten years. We anticipate new Texas rates, based on the final order, to be implemented by late April 1988.

All construction prudence issues directly related to Palo Verde Units 1 and 2, and any effect which those construction issues might have had on Unit 3, have been settled by the Commission's adoption of the stipulation. Issues relating to the prudence of the Company's decisions with respect to its investment in Palo Verde are also settled insofar as those issues affect regulatory treatment of Units 1 and 2. In order to settle these issues, we had agreed, in the October 1987 stipulation, to an after-tax regulatory disallowance of approximately $24.4 million of our investment in Palo Verde (which is less than 2% of that investment). We recorded this disallowance, which did not require cash, in 1987.

All issues relating to excess capacity with respect to Units 1 and 2 are resolved under the approved rate moderation plan for the life of the phase-in period. Certain issues relating to the prudence of the construction costs specifically incurred with respect to Unit 3, decisional prudence issues, as they affect regulatory treatment of Unit 3, relating to events occurring after the 1978 issuance of a certificate of convenience and necessity for Palo Verde by the Texas Commission and any possible issues of excess capacity relating to Unit 3 are, under the plan, reserved for future decision when the Company requests Unit 3 costs be included in Texas rates. We expect to request Unit 3 in rates in 1990.

Adoption of the rate moderation plan by the Texas Commission constitutes an effective long-term resolution of the rate treatment of our investment in Palo Verde Units 1 and 2. Our congratulations and appreciation go to the many fine officers of the Company who worked so very hard to achieve this outstanding result.

Further information regarding the Texas Commission's action is provided in the section of the Company's Form 10-K regarding rate matters. A copy of the Form 10-K is included with this report.

Sincerely,

EVERN R. WALL
Chairman of the Board
and Chief Executive Officer

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended December 31, 1987

Commission File Number 0-296

El Paso Electric Company

(Exact name of registrant as specified in its charter)

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

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

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

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

Common Stock, no par value
(Title of Class)

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

As of February 29, 1988, the aggregate market value of the voting stock held by non-affiliates of the registrant was $491,901,509.

As of February 29, 1988, there were outstanding 34,977,902 shares of Common Stock, no par value.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for the annual meeting of its shareholders to be held in May 1988 are incorporated by reference into Part III of this report.

DEFINITIONS

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

Abbreviations or Acronyms	Terms
AFUDC	Allowance for Funds Used During Construction
APS	Arizona Public Service Company
Common Plant or Common Facilities	Facilities at or related to the Palo Verde Station that are common to all three Palo Verde Units
Community	Salt River Pima-Maricopa Indian Community
Company	El Paso Electric Company
CWIP	Construction Work in Progress
DOE	United States Department of Energy
FERC	Federal Energy Regulatory Commission
FL&R	Franklin Land & Resources, Inc., a subsidiary of the Company
Four Corners	Four Corners Project or Four Corners Plant
IID	Imperial Irrigation District, an irrigation district in Southern California
KV	Kilovolt
KW	Kilowatt(s)
KWH	Kilowatt-hour(s)
MW	Megawatt(s)
NASDAQ	National Association of Securities Dealers Automated Quotations System
New Mexico Commission	New Mexico Public Service Commission
NRC	Nuclear Regulatory Commission
Palo Verde Station or Palo Verde Project or Palo Verde or PVNGS	Palo Verde Nuclear Generating Station
PasoTex	PasoTex Corporation, a subsidiary of the Company
PNM	Public Service Company of New Mexico
RGEC	Rio Grande Electric Cooperative, Inc.
SCE	Southern California Edison Company
SFAS	Statement of Financial Accounting Standard
SRP	Salt River Project Agricultural Improvement and Power District
Texas Commission	Public Utility Commission of Texas
TNP	Texas-New Mexico Power Company
Tribe	Navajo Indian Tribe
1988 Proxy Statement	Company's definitive proxy statement for the annual meeting of shareholders to be held in May 1988

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PART I

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

PART I

Item 1. Business

General

The Company was incorporated in Texas in 1901. Its principal business is the generation and distribution of electricity through an interconnected system to approximately 227,000 customers in El Paso, Texas and in an area in the Rio Grande Valley in Texas and New Mexico. The Company's principal executive offices are located at 303 North Oregon Street, El Paso, Texas 79901 (telephone 915-543-5711).

The Company's service area extends approximately 110 miles northwesterly from El Paso to the Caballo Dam in New Mexico and approximately 120 miles southeasterly from El Paso to Van Horn, Texas. The service area has an estimated population of 660,000, including approximately 500,000 people in the metropolitan area of El Paso. Copper smelting and refining, oil refining, garment manufacturing, cattle raising and agriculture are important industries in El Paso, which is also an important transportation and distribution center. At December 31, 1987, the Company's largest retail customers included a copper refinery, a smelter, and a steel fabricator in El Paso (an indirect subsidiary of the Company), and important military installations, namely the U.S. Army Air Defense Center at Ft. Bliss in El Paso and the White Sands Missile Range and Holloman Air Force Base in New Mexico. The Company derives a significant portion of its operating revenues from wholesale power sales. See "Rates and Regulation — Rate Matters — FERC."

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

During 1987, approximately 64% of the Company's operating revenues were derived from Texas, 19% from New Mexico and 17% from FERC wholesale customers. Sales to (i) residential customers, (ii) small commercial and industrial customers, (iii) large commercial and industrial customers and (iv) public authorities accounted for approximately 36%, 34%, 12% and 18%, respectively, of the Company's operating revenues from retail sales. In 1987, IID, a wholesale customer, accounted for 10.1% of operating revenues. No retail customer accounted for more than 3% of operating revenues. The effect of seasonal sales by quarter are insignificant to the Company's annual operating revenues, but the third quarter of each calendar year traditionally contributes more than 25% of annual revenues due to the climate in the Company's service area. (See Note M of Notes to Consolidated Financial Statements.)

The Company attained an all-time total system peak load of 975 MW on August 7, 1987. In 1986, the Company's total system peak load was 938 MW. In 1987 and 1986, the native system peak load was 820 MW and 790 MW, respectively. The Company periodically makes long-range projections of system peak load and estimates future sources of power that may be used to supply the system requirements. The projected annual peak load growth rate for the Company's service area during the 1988-1997 time period is approximately 2.8%.

The Company had 1,109 employees as of December 31, 1987. Approximately 28% of the employees are covered by a collective bargaining agreement that expires in February 1989.

In addition to its electric utility operations, the Company has various subsidiaries which engage in unregulated, non-utility businesses. See "Company Conditions — Non-Utility Operations", "Non-Utility Operations" and Note N of Notes to Consolidated Financial Statements.

Company Conditions

Construction Program. The Company's major construction project for the past decade has been related to its 15.8% interest in the three 1,270 MW nuclear generating units which comprise the Palo Verde Station, which is located near Phoenix, Arizona. Unit 1 and Unit 2 were placed in commercial operation on February 24, 1986 and September 22, 1986, respectively. Unit 3 received its full power license from the NRC on November 25, 1987 and attained commercial operation on January 11, 1988. Through December 31, 1987, the Company has expended approximately $1.42 billion for its investment in Palo Verde Station. The Company sold and leased back 100% of Unit 2 in 1986 and approximately 39.5% of Unit 3 in December 1987. The Company remains responsible, under the terms of the leases, for all operation and maintenance costs, decommissioning costs, nuclear fuel costs, and other related operation costs of the leased facilities. The Company does not expect to construct additional base load generating facilities during this century. With the exception of a transmission line currently under construction, the Company's major construction activities for this century are complete. See "Utility Construction Program and Financing Capability."

Rate Matters. The Company's utility rates are regulated by three separate regulatory bodies — the Texas Commission, the New Mexico Commission and FERC. Collectively, these regulatory authorities have the authority and the responsibility for establishing rates which will provide the Company with a return of and a return on its investment in utility plant, to the extent the investment was prudently incurred and is used and useful in serving the Company's customers, as well as a recovery of utility operating costs. Because of the magnitude of the Company's investment in, and lease obligations related to, the Palo Verde Station, and the consequent rate spike effect which would occur through traditional rate making approaches, the Company has pursued rate moderation plans with its regulators. In doing so, the Company seeks to maintain the traditional utility pricing objective of rate continuity in an effort to avoid possible adverse effects on load growth (demand), while providing a level of current cash rate relief that is adequate to meet the Company's needs. Stipulations have been approved by both the New Mexico Commission (May 1987) and the Texas Commission (March 1988), which contain rate moderation plans. The Company believes that both of these plans meet the Company's objectives described in this paragraph. See "Rates and Regulation."

Non-Utility Operations. The Company, through its unregulated subsidiary, FL&R, has, for several years, been engaged in various non-utility operations, principally involving real estate. In 1987, the Company, through its subsidiary, PasoTex, committed a substantial investment in a plan to diversify further into unregulated, non-utility operations. Approximately $110 million of the proceeds from the Palo Verde Unit 2 sales and leasebacks have been used in funding the diversification plan. The primary goal of the plan is to earn a rate of return on its investment in diversification at least equal to its regulated utility authorized rate of return and thereby recover that portion of the lease payments on Unit 2 in excess of the book value of the plant sold and leased back, which has been allowed into rates. Additionally, the Company believes that its diversification plan should bring industrial and commercial businesses into its service areas to provide new jobs and economic development, thereby broadening the base of the Company's utility customers and resulting in lower per KWH fixed costs for the Company's utility operations. See "Rates and Regulation — Regulatory Authorities — New Mexico."

The Company believes that the principal factors which will affect the future financial position and results of operations of the Company will be the attainment of the Company's projected increases in load growth (demand), the inclusion in rate base of Unit 3 in the Texas jurisdiction and the ability of the Company to finance the effects of its Texas and New Mexico rate moderation plans, which, in part, depends upon the ability of the Company's unregulated operations to earn an adequate rate of return and level of cash flow.

Rates and Regulation

Regulatory Authorities

Texas. The rates and services of the Company in Texas municipalities are regulated by those municipalities and in unincorporated areas by the Texas Commission. The Texas Commission has exclusive de novo appellate jurisdiction to review municipal orders and ordinances, and its decisions are subject to judicial review.

New Mexico. The New Mexico Commission has authority over the Company's rates and services in New Mexico, the issuance of securities by the Company and other matters affecting the operations of the Company, including the Company's general diversification plan, which, in November 1987, was approved by the New Mexico Commission. See "Non-Utility Operations."

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

NRC. The Palo Verde Station is subject to the jurisdiction of the Nuclear Regulatory Commission (the "NRC"), which has authority to issue permits and licenses and to regulate nuclear facilities in order to protect the health and safety of the public from radiation hazards and to conduct environmental reviews pursuant to the National Environmental Policy Act. Before any nuclear power plant can become operational, an operating license from the NRC is required. The NRC has granted facility operating licenses for Unit 1, Unit 2 and Unit 3 for terms of forty years each beginning December 31, 1984, December 9, 1985 and March 25, 1987, respectively. See "Utility Construction Program and Financing Capability — Palo Verde Station" and "Facilities — Palo Verde Station."

Rate Matters

Texas

March 1988 Rate Order. On March 22, 1988, the Texas Commission adopted, with certain modifications, the rate moderation plan that the Company and most of the parties to the Texas rate case had agreed to in an October 22, 1987 stipulated settlement of the case. The Commission is expected to issue its final order in the case, which will be based on the modified stipulation, by the end of March 1988. The Company's rate filing in April 1987, as amended, had requested a $77 million increase in annual Texas base rates, premised primarily upon (i) full inclusion in rate base of the Company's capital costs for Unit 1 at Palo Verde, Palo Verde deferred costs and two-thirds of the capital costs of Palo Verde Common Facilities and (ii) inclusion in cost of service of the Company's lease payments on Unit 2 to the extent of the book value of the plant sold and leased back.

The rate moderation plan adopted by the Texas Commission, which is intended to comply with SFAS No. 92, *Regulated Enterprises — Accounting for Phase-in Plans,* provides for a phased-in increase in the Company's annual Texas retail base rates of approximately $46 million (which is approximately 60% of the $77 million increase requested by the Company). The Company will receive cash rate increases of approximately $21 million in the first twelve months of the plan ($8.6 million net of fuel savings and miscellaneous revenues) and $7 million in each of the following three twelve-month periods. On a percentage basis, Texas base rates will increase by 13.7% in the first year of the plan (3.6% net of fuel savings and miscellaneous revenues), 4% in the second year of the plan and 3.5% in each of the third and fourth years of the plan. Base rates under the plan are expected to remain constant after the fourth rate increase through 1997. The deficiency in revenues resulting from these scheduled rate increases is deferred for collection in later years. All such deferrals are scheduled to be recovered within ten years. New Texas rates, based on the final order, are expected to be implemented by late April 1988.

All construction prudence issues directly related to Palo Verde Units 1 and 2 and Common Plant, and any effect which Unit 1 and 2 construction issues might have had on Unit 3, are settled by the Commission's adoption of the modified stipulation. Issues relating to the prudence of the Company's decisions with respect to its initial and continuing investment in Palo Verde are also resolved insofar as they affect regulatory treatment of Units 1 and 2. In order to settle these issues, the Company had agreed, in the October 1987 stipulation, to an after-tax regulatory disallowance of approximately $24.4 million of the Company's investment in PVNGS (less than 2% of such investment). The Company recorded the disallowance, which did not require cash, in 1987.

All issues relating to excess capacity with respect to Units 1 and 2 are resolved under the plan for the life of the phase-in period. Certain issues relating to the prudence of construction costs specifically incurred with respect to Unit 3, decisional prudence issues, as they affect regulatory treatment of Unit 3, relating to events occurring after the 1978 issuance of a certificate of convenience and necessity for Palo Verde by the Texas Commission and any possible issues of excess capacity relating to Unit 3 are, under the terms of the plan, reserved for future decision when the Company requests Unit 3 costs be included in Texas rates. Although Unit 3 achieved commercial operation in January 1988, it will not meet present Texas in-service rate criteria until completion of additional transmission facilities, presently scheduled for the end of 1989. Until Unit 3 meets such in-service criteria, it will be accounted for, insofar as the Texas jurisdictional portion is concerned, as plant under construction, and the Company will continue to capitalize all Texas jurisdictional costs of owning, operating and maintaining Unit 3 and will continue to accrue related AFUDC on Unit 3.

The Texas Commission deferred for future decision the recovery of regulatory expenses in the case and the issue of whether the Unit 2 sale and leaseback transactions were in the public interest. The Company's recovery of the expenses incurred by the Company and the City of El Paso in trying the case will be the subject of a separate hearing and order. All such expenses subsequently determined to be chargeable to ratepayers are provided to be recovered by the Company by means of a surcharge to Texas customers. As required by statute, the Company filed a report of the Unit 2 sale and leaseback transactions with the Texas Commission. When adopting the rate moderation plan, the Texas Commission included the effect of the Unit 2 transactions in rates because rates recognizing the transactions in the present case would not exceed those under traditional ratemaking methodology. However, the Commission specifically reserved a ruling on the question whether the transactions were in the public interest and should be reflected in rates in the future in lieu of such traditional methodology. The Company believes that the sale and leaseback transactions were an integral part of the rate moderation proposal and expects to be able to recover in rates the lease payments to the extent of the book value of the plant sold and leased back. See Note D of Notes to Consolidated Financial Statements.

The Company believes that the rate moderation plan adopted by the Texas Commission provides an adequate level of cash rate relief while enabling the Company to defer operating costs and its return on a substantial portion of its investment for subsequent recovery. Additionally, the Company believes that the settlement adopted by the Texas Commission and the phase-in plan contained therein provide an effective long-term resolution of the rate treatment of the Company's investment in PVNGS Units 1 and 2 and Common Plant. Management does not expect the ultimate resolution of the remaining issues of prudence relating to Unit 3 to result in a material disallowance of the costs incurred on Unit 3. The Company believes that if any excess generating capacity were to be found by the Texas Commission relating to Unit 3, the amount of any resulting exclusion from rate base would likely be temporary and would be restored to rate base in future rate proceedings to permit full recovery of substantially all of the Company's Texas jurisdictional investment in Unit 3.

Fuel Savings. In its Texas jurisdiction, the Company is entitled to recover its fuel costs by means of a fixed fuel factor approved by the Texas Commission. The fuel factor is reviewed and approved in each rate case filed by the Company, and the Texas Commission has the authority to order fuel reconciliation on its own initiative after hearing. During 1987, the Company filed for authority from the Texas Commission to refund to Texas retail customers approximately $13.3 million in fuel savings

achieved by the Company, the refund representing amounts overrecovered through the Company's fixed fuel factor. Pursuant to Commission authorization, the requested refunds were made by credit to bills.

New Mexico

In January 1987, the Company filed with the New Mexico Commission for an $18.7 million increase in annual New Mexico base rates (an increase of approximately $13.9 million net of fuel savings), premised primarily upon the continued full inclusion in rate base of the capital costs of Unit 1 and one-third of Palo Verde Common Facilities and inclusion in cost of service of the operating and maintenance expenses for Units 1 and 2 and the lease payments on Unit 2 to the extent of the book value of the plant sold and leased back. In March 1987, the Company entered into a stipulated settlement of the case with certain jurisdictional parties which provided for a rate moderation plan. On May 18, 1987, the New Mexico Commission issued its final order in the case and adopted the rate moderation plan set forth in the stipulated settlement. The approved plan provides for (i) continued full inclusion in the Company's rate base of the capital costs of Palo Verde Unit 1 and one-third of Palo Verde Common Plant and inclusion in rate base of certain transmission facilities, (ii) recovery of the New Mexico portion of equity AFUDC attributable to Unit 3 in rates as cost of service, amortized over a period ending December 31, 1994, subject to acceleration based upon recoupment of the cost of service deferrals described in the clause next following, (iii) increases in rates of 3% on a total cents per kilowatt-hour basis in 1987, 3% in base rates no sooner than one year after the 1987 increase and an additional 3% in base rates no sooner than one year after the second 3% increase, with any deficiency in revenue requirements resulting from this rate path being deferred for collection in later years (base rates to be held constant after the third increase until the earlier of December 31, 1994 or the full recoupment of such deferrals and the New Mexico portion of equity AFUDC attributable to Unit 3), (iv) recovery in rates of the lease payments on Unit 2 to the extent of the book value of plant sold and leased back, as well as all related taxes, (v) agreement by the Company that, except for the New Mexico portion of equity AFUDC attributable to Unit 3, neither the capital costs of Palo Verde Unit 3 nor one-third of Palo Verde Common Plant and a proportionate share of certain Palo Verde transmission facilities nor any Unit 3 operating expenses will at any time be requested for inclusion in the Company's rate base or requested for any cost of service treatment insofar as the New Mexico jurisdiction is concerned, (vi) resolution of any possible issue related to the prudence of the planning, management and construction of Palo Verde and (vii) settlement of any possible issue of excess generating capacity through 1993. Based upon present planning analyses, the Company does not expect to have excess generating capacity. Under the approved rate moderation plan, any portion of cost of service deferrals not recouped prior to December 31, 1994 will not be recovered through rates in New Mexico.

SFAS No. 92, issued in August 1987 and effective for financial statements for fiscal years beginning after December 15, 1987, establishes specific criteria to be met by a phase-in plan in order for costs deferred for future recovery by the regulator to be capitalized for financial reporting purposes. The rate moderation plan approved in New Mexico does not currently meet such criteria. The Company, however, has commenced negotiations with the parties to the New Mexico stipulation to amend the plan to meet the criteria of SFAS No. 92 and believes that such amendment will be approved by the New Mexico Commission.

The first of the three scheduled rate increases, pursuant to the New Mexico rate moderation plan, was approved in November 1987 and provides an annual increase in the Company's New Mexico base rates of $9.9 million, or $5.0 million in total revenues, net of fuel savings. Actual revenues to be collected by the Company pursuant to the phase-in of the approved increase aggregate $6.6 million of base revenues, or $1.8 million in total revenues, net of fuel savings. The difference between the approved base revenue increase of $9.9 million and the implemented increase of $6.6 million will be deferred. The new rates went into effect in November 1987. On November 20, 1987, the Company filed for the second increase under the rate moderation plan in the amount of approximately $5.5 million. Under the phase-in provisions of the plan, such increase will be limited to 3%, or $1.7 million with the

balance to be deferred. The new rates, which are subject to the approval of the New Mexico Commission, are expected to be effective in November 1988. The ability of the Company to defer for financial reporting purposes amounts equal to the difference between the approved and implemented rates (approximately $3.3 million in 1988) is dependent upon the approval of the parties to the stipulation and by the New Mexico Commission of the Company's request to amend the rate moderation plan to meet the requirements of SFAS No. 92.

As stated above, the New Mexico rate moderation plan provides that neither the capital costs of Palo Verde Unit 3, one-third of Common Plant and a proportionate share of certain Palo Verde transmission facilities (aggregating approximately $54.1 million) nor any Unit 3 operating expenses, including the lease payments attributable to that portion of Unit 3 sold and leased back on December 31, 1987, will at any time be included in the Company's rates or receive any cost of service treatment insofar as the New Mexico jurisdiction is concerned. The costs related to the New Mexico portion of Unit 3 will need to be recovered through sales of power to additional wholesale customers. The Company believes, based upon current market conditions and forecasts of power demand, that it will recover its costs related to the New Mexico portion of Unit 3.

Fuel Savings. In its New Mexico jurisdiction, the Company is entitled to recover its fuel costs through a fuel factor approved by the New Mexico Commission. The rate moderation plan approved in New Mexico provides that the fuel factor will be fixed each year during the life of the phase-in plan, with such fuel factor to remain in effect for one year unless the New Mexico Commission orders fuel reconciliation due to material over or under recovery of fuel costs. In 1987, the Company filed for authority from the New Mexico Commission to refund to New Mexico retail customers approximately $6.2 million in fuel savings achieved by the Company. Pursuant to Commission authorization, the requested refund was made by credit to customer bills during the June 1987 and February 1988 billing cycles.

FERC

The Company's sales for wholesale power make up a significant portion of the Company's operating revenues. During 1987 and 1986, approximately 17% and 12%, respectively, of the Company's electric operating revenues resulted from such sales. Rate tariffs currently applicable to FERC wholesale customers contain appropriate fuel and purchased power cost adjustment provisions designed to recover those costs in excess of costs included in base rates.

In March 1986, the Company filed for increased rates for service to three wholesale customers, IID, TNP and RGEC. The requested increase amounted to approximately $32 million, utilizing a forecasted 1986 test period. In May 1986, the Company was allowed to implement a portion of the increased rates under suspension. The Company subsequently entered into settlement agreements with each of these customers. The FERC approved the settlements with IID and RGEC on March 30, 1987. The settlement with IID is based upon a long-term firm power sales agreement providing for the sale of 100 megawatts of firm capacity to IID beginning in 1987 and continuing through April 2002. In addition, the agreement calls for contingent capacity of 50 megawatts to be made available to IID beginning in 1992 and continuing through April 2002. The settlement agreement with IID settles any possible issue of the prudence of the construction costs of PVNGS and of excess generating capacity. The settlement agreement with TNP is based upon a revised firm power sales agreement with TNP. As part of the settlement of the rate increase request, the Company and TNP settled an arbitration with respect to the contractual level of reserve demand under the Company's prior sales agreement with TNP. The revised firm power sales agreement with TNP provides for firm power sales to TNP ranging from 43 megawatts to 79 megawatts, beginning in 1987 and continuing through 2002, with negotiated demand charge rates for such power.

On December 29, 1987, the FERC approved with modifications the settlement with TNP. The Commission refused to bind itself to certain contractual provisions contained in the settlement. TNP and the Company have asked for a rehearing by the Commission on its order and have asked the FERC to allow the Company to place the agreed upon rates for 1988 in effect. The Company and TNP have

agreed on the impact of the sale and leaseback of Unit 3 on the demand charges during the term of the contract.

The Company and RGEC have agreed to a 10-year contract based on a flat rate during the life of the contract. The Company has filed the contract for approval before the FERC.

Palo Verde Performance Standards

In New Mexico, the Company is subject to performance standards for operation of the Palo Verde units. The standards measure performance on the basis of all three units viewed as a whole. These standards set designated levels of capacity factors (the ratio of actual generation to maximum possible generation) at the Palo Verde Station. If the capacity factors exceed the maximum standard (75 percent), the Company is rewarded based upon the additional fuel costs avoided, calculated on the basis of the Company's weighted average fuel and purchased power costs (other than Four Corners, Palo Verde and purchases from Southwestern Public Service Company). If the capacity factors fall below the minimum standard (60 percent), the Company is penalized based upon the additional fuel costs incurred using the same formula. If performance falls between the minimum and maximum standards, no consequences result. For the period most recently completed, performance at Palo Verde resulted in neither a penalty nor a reward. The Company expects to agree to similar performance standards in Texas.

Utility Construction Program and Financing Capability

Construction Program

The Company's estimated construction costs for 1988 through 1991 set forth in the table below are approximately $198 million, consisting of approximately $185 million in cash and approximately $13 million in related AFUDC, net of deferred tax. The estimated costs were prepared as of March 1, 1988. For a number of reasons, actual costs may vary from the construction program estimates set forth below. Such estimates are reviewed and modified from time to time to reflect changed conditions.

	1988	1989	1990	1991
		(In thousands)		
Production:				
PVNGS(1)(4)	$ 8,700	$ 1,500	$ —	$ —
Other	8,900	10,200	7,700	7,300
Transmission:				
PVNGS	10,400	—	—	—
Other	12,800	19,500	1,900	4,300
Distribution	20,200	22,600	18,800	14,000
General Plant	5,900	3,400	3,600	3,700
AFUDC(2):				
PVNGS(4)	1,900	200	—	—
Other	3,600	5,700	1,600	1,800
Deferred Tax on AFUDC(3)	(700)	(800)	(200)	(200)
Total	$71,700	$62,300	$33,400	$30,900

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

(2) AFUDC has been calculated using an estimated accrual rate of 10.5%. Certain amounts of construction work in progress ("CWIP") have been previously allowed in the Company's rate base and the appropriate amounts have been excluded from the CWIP balance used as a base for calculating AFUDC. AFUDC on major projects has been compounded on a semi- annual basis.

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

(4) Does not include the Texas jurisdictional costs of owning, operating and maintaining Unit 3 or the accrual of related AFUDC on Unit 3 which the Company will continue to capitalize until Unit 3 meets present Texas in-service criteria (see "Rates and Regulation — Rate Matters — Texas").

The Company has begun construction on its Arizona Interconnection Project ("AIP"). This project involves the installation of a new 345 KV transmission line and associated substation equipment along a 313-mile path originating at Springerville Generating Station in Springerville, Arizona and terminating at the Rio Grande Power Plant in Dona Ana County, New Mexico (northwest of El Paso). The AIP will enable the Company to import low cost energy from the Arizona-New Mexico power grid, enhance system reliability, and access its entire PVNGS nuclear capacity entitlement. Through construction of the AIP, the Company will be better equipped to meet future strategic generating resource mix requirements and will continue to benefit from economy energy purchases. Costs associated with this project are included in the table above in Transmission-PVNGS and Other.

Net utility plant at December 31, 1982, was $1,006,529,000. Gross additions to plant, including CWIP, for the five years ended December 31, 1987, totaled $1,023,700,000 (the largest portion of which was $768,600,000 for PVNGS). Net utility plant at December 31, 1987 (which reflects sales of plant in the Palo Verde sale and leaseback transactions), was $1,215,882,000 (including capitalized nuclear fuel of approximately $68,848,000 leased from a nuclear fuel trust. See "Energy Sources — Nuclear Fuel.").

The Company does not expect to construct additional base load generating facilities during this century. With the exception of the AIP transmission line described above, the Company's major construction activities for this century are complete.

Palo Verde Station

The Company has a 15.8% interest in the three 1,270 MW nuclear generating units and Common Plant at the Palo Verde Station near Phoenix, Arizona (owned as to Unit 1 and approximately 60% of Unit 3, and leased as to Unit 2 and approximately 40% of Unit 3). The participants in the Palo Verde Project include the Company and six other utilities: Arizona Public Service Company, Southern California Edison Company, Public Service Company of New Mexico, Southern California Public Power Authority, Salt River Project Agricultural Improvement and Power District and the Los Angeles Department of Water and Power. Participants share costs and generating entitlements in the same proportion as their percentage interests in the generating units. APS serves as Project Manager and Operating Agent for the Palo Verde Station. In February 1977 and November 1978, respectively, the New Mexico Commission and the Texas Commission issued certificates of convenience and necessity for the Company's participation in the Palo Verde Station.

The table below sets forth the costs incurred by the Company through December 31, 1987, with respect to the construction of PVNGS (including the cost of start-up and testing and the Company's share of the cost of related switchyard and transmission facilities), and the Company's estimate of the cumulative cost of construction through the completion of PVNGS. Such table does not, however, include the Company's share of the estimated cost of nuclear fuel. (See "Energy Sources — Nuclear Fuel") The estimated costs were prepared as of March 1, 1988.

	Actual Costs Through December 31, 1987	Estimated Cumulative Costs Through December 31, 1988	1989
		(In thousands)	
Nuclear Plant	$ 977,900	$ 986,600	$ 988,100
Related AFUDC	506,400	507,000	507,200
Transmission Lines and Switchyard	24,000	34,400	34,400
Related AFUDC	9,900	11,200	11,200
Deferred Tax on AFUDC	(103,100)	(103,400)	(103,400)
Total	$1,415,100	$1,435,800	$1,437,500

The above table includes approximately $653.4 million in aggregate book value of the undivided interests involved in the Unit 2 and Unit 3 sale and leaseback transactions in which the related leases are accounted for as operating leases. Such book value no longer appears as an asset of the Company. The table above does not reflect a regulatory disallowance write-off of approximately $38.3 million. See Notes B and D of Notes to Consolidated Financial Statements.

Palo Verde Sales and Leasebacks

In August and December 1986, the Company sold and leased back all of its 15.8% undivided interest in Unit 2 and one-third of its interest in certain Common Plant at Palo Verde for approximately $684.4 million cash. In December 1987, the Company sold approximately 39.5% of its undivided 15.8% interest in Unit 3 for approximately $250 million cash. For a description of the terms and provisions of these transactions, see Note D of Notes to Consolidated Financial Statements. The proceeds from the Unit 2 and Unit 3 sale and leaseback transactions have been used and will be used to retire long and short-term debt, make preferred stock redemptions and meet other cash requirements, including construction expenditures. $100 million of the sale and leaseback proceeds have been used to redeem two separate series of First Mortgage Bonds. One series, due in 2012, in the principal amount of $60 million, bore interest at 16.20% per annum and was redeemed in February 1988. The other series, due 1991, in the principal amount of $40 million, bore interest at 16.35% per annum and was redeemed in May 1987. $150 million of the proceeds have been used to prepay in August 1986 and January and March 1988 $150 million principal amount of bank debt secured by a like principal amount of second mortgage bonds. $75 million of the bank debt was due in August 1987 and the balance was due in June 1988. Approximately $110 million of the proceeds have been used to fund the Company's diversification program.

Contemporaneously with the consummation of the Unit 3 sale and leaseback transactions, the Company and the equity investors in the Unit 2 sale and leaseback transactions agreed to modifications of the documents for those transactions. The modifications require that the Company provide each of the six equity investors in the August 1986 Unit 2 sale and leaseback transactions with a bank letter of credit, having a term expiring not earlier than December 31, 1991, in support of the equity portion of rent under the related lease. In addition, the Company agreed to certain financial covenants with each of the eight equity investors in the Unit 2 sale and leaseback transactions requiring the Company to be in compliance at June 30, 1991 with specified interest and rental payment coverage ratios and debt to capitalization tests. If the Company fails to meet such financial covenants at that time, the equity investor can, in lieu of exercising remedies under the related lease, including drawing on the letter of

credit, elect to require that the letter of credit be renewed for successive one year periods until such financial covenants are met as of June 30 in a subsequent year.

As part of the modifications, the Company agreed to place in a bank escrow account, pending the satisfaction of the conditions described below, $243.1 million, to be used to retire all of the long-term debt of the Company maturing during the period from June 1988 through February 1991. $138 million of the proceeds from the Unit 3 sale and leaseback transactions were placed in the escrow, and the Company funded the balance of the escrow by transferring certain investments to the escrow account. During March 1988, the Company prepaid, with funds withdrawn from the escrow account, $50 million principal amount of bank debt due in June 1988. Approximately $205.4 million is presently held in escrow.

The escrowed funds are to be released upon (i) delivery of the letters of credit to the six equity investors in the August 1986 Unit 2 sale and leaseback transactions and (ii) execution and delivery of the amendments to the transaction documents for the Unit 2 sale and leaseback transactions required to implement the agreed upon modifications. If such letters of credit are not delivered by April 30, 1988, each subsequent rent payment under the six related leases is, under the terms of the modified agreements, to be increased by .35 percent of facility cost, such rent increase to continue until the earlier to occur of (x) the date of delivery of the required letter of credit and (y) the date as of which such letter of credit would have expired had it been in effect as required. The Company has commenced negotiations to secure the required letters of credit and expects that it will be able to provide such letters of credit and terminate the escrow.

Future Cash Requirements

The requirements of the Company and its subsidiaries for cash during the period 1988-1991 relate primarily to the maturities of long-term debt and redemption of and sinking fund payments related to preferred stock (approximately $285 million) and construction expenditures (approximately $185 million). The Company's ability to generate cash from utility operations during this time period will be affected by the deferral of revenues pursuant to the phased-in increases in Texas and New Mexico and the costs of operating Unit 3 prior to receiving rate relief, which is currently anticipated in 1991.

Such cash requirements through 1991 will be met primarily through utilization of the proceeds of the Unit 2 and Unit 3 sale and leaseback transactions. The Company anticipates utilizing short-term borrowings to supplement its internally generated cash in order to meet its needs for operations and dividends during the period 1988-1991. The Company believes that short-term debt available pursuant to the restrictions discussed below provides sufficient short-term borrowing capability to meet the requirements of the Company and its subsidiaries.

Restrictions on Financing Capabilities

In connection with the modifications in December 1987 of the Unit 2 sale and leaseback transaction documents (see "Palo Verde Sales and Leasebacks" above), certain covenants in the Unit 2 sale and leaseback transaction documents restricting the incurrence of additional debt by the Company and its subsidiaries were modified. Subsequent to December 31, 1987 the Company repaid $132 million of its outstanding short-term borrowings. After giving effect to such repayment, the Company and its subsidiaries could, under the Unit 2 sale and leaseback debt incurrence tests, incur, in the aggregate, approximately $207 million of additional short-term debt. Upon release of the escrowed funds, and after giving effect to the repayment of short-term debt subsequent to December 31, 1987, the debt incurrence tests would permit the Company and its subsidiaries to incur short-term debt aggregating $231 million. The amount of short-term debt the Company itself, without inclusion of the subsidiaries, can incur is, under present FERC authorization capped at $200 million outstanding at any one time (see "Short-Term Obligations" below). The Company and its subsidiaries are presently precluded and expect to be precluded under the Unit 2 tests from issuing additional long-term debt until after December 31, 1988, at the earliest. At such time, the Company may be required, in order to

issue additional long-term debt, to establish a new escrow of cash for debt retirements, which under the Unit 2 tests, serves as a defeasance of debt for purposes of the debt incurrence tests . Neither the Company nor its subsidiaries currently anticipate the need for any significant additional long-term debt financing until after 1991.

In addition to the debt incurrence restrictions of the Unit 2 sale and leaseback transaction documents, external financing by the Company is also subject to restrictions found in the Company's First and Second Mortgage Indentures, its Restated Articles of Incorporation and certain bank credit agreements, the provisions of which are presently less restrictive than the restrictions of the Unit 2 sale and leaseback transactions. The debt incurrence tests of the Unit 2 sales and leasebacks apply to any form of long or short-term debt issued by the Company and its subsidiaries, including first and second mortgage bonds.

Short-Term Obligations

At December 31, 1987, the Company had short-term obligations outstanding of approximately $142 million, consisting of approximately $102 million in commercial paper and approximately $40 million in notes payable and other obligations. The Company subsequently has reduced short-term obligations to approximately $10 million at March 3, 1988. The Company maintained informal lines of credit which totaled approximately $152 million at December 31, 1987.

The amount of short-term obligations which the Company may incur is regulated by the FERC. The FERC has authorized the Company to incur short-term obligations, with maturities no later than December 31, 1988, in an amount not to exceed $200,000,000 outstanding at any one time.

For a description of short-term obligations of the subsidiaries, see Note I of Notes to Consolidated Financial Statements.

Facilities

General

As described below, the Company currently has a net generating capacity of 1,497 MW, consisting of 246 MW at Rio Grande, 478 MW at Newman, 69 MW at Copper, an entitlement of 104 MW from Four Corners and an entitlement of 600 MW from Palo Verde Units 1, 2 and 3. See "Company Conditions."

Rio Grande Power Station

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

Newman Power Station

Newman, located in El Paso, consists of three steam-electric units with an aggregate capability of 266 MW and one combined-cycle unit with a capability of 212 MW. The units regularly operate on natural gas, but are also capable of operating on fuel oil. If they were to operate entirely on fuel oil, operating and maintenance costs would increase and capacities would be lower. See "Energy Sources."

Copper Power Station

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

Four Corners Project

The Company has an undivided 7% interest in Units 4 and 5 at Four Corners located in northwestern New Mexico. Each of the coal-burning generating units have the capability of 739 MW. For emergencies each Unit is rated at 784 MW. Both units are located adjacent to a surface-mined supply of coal and are jointly owned by the Company, APS (which is the Operating Agent for Four Corners), Tucson Electric Power Company, PNM, SCE and SRP. The Company's entitlement of 104 MW is used for the Company's base load to the maximum extent possible.

The Four Corners Plant is located on land held under easements from the Federal Government and also under a lease from the Tribe, the enforcement of which might require Congressional consent. The risk with respect to the enforcement of these easements and of the lease is not deemed by the Company to be material. The Company is dependent, however, in some measure upon the willingness and ability of the Tribe to protect these properties and honor its commitments. Certain of the transmission lines and almost all of the contracted coal sources for the Four Corners Plant are located on the Tribe's reservation.

The participants in Four Corners are defendants in a suit filed by the State of New Mexico in March 1975 in state district court in New Mexico, against the United States of America, the City of Farmington, New Mexico, the Secretary of the Interior as Trustee for the Navajo and other Indian tribes, and certain other defendants. The suit seeks adjudication of the water rights of the San Juan River Stream System in New Mexico, which, among other things, supplies the water used at Four Corners. No trial date has been set in this matter. An agreement reached with the Tribe in 1985 provides that if the Four Corners Plant loses a portion of its rights in the adjudication, the Tribe will provide sufficient water from its allocation to offset the loss.

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

Palo Verde Station

For information regarding the Company's interest in the Palo Verde Station, see "Company Conditions," "Rates and Regulation," and "Utility Construction Program and Financing Capability." For a description of nuclear fuel acquisition, see "Energy Sources — Nuclear Fuel."

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

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

settlement requires federal legislation for effectuation and would have no adverse impact on the primary effluent contract.

In November 1982, certain operators of farms located in the vicinity of the Palo Verde site filed a lawsuit in Maricopa County Superior Court claiming prior rights to effluent to be delivered to Palo Verde under the primary and secondary effluent contracts. In January 1984, the Operating Agent for Palo Verde joined with another Palo Verde participant in bringing an action in an Arizona state court against the plaintiffs in the foregoing lawsuit and an owner of land in the river basin from which the effluent to be received under the primary contract is alleged to be derived, seeking a declaratory judgment as to rights to effluent under Arizona law. This declaratory judgment action was consolidated in the Arizona state court with the lawsuit filed in November 1982. In October 1985, the state court ruled in favor of the Palo Verde participants in these consolidated lawsuits, holding that the effluent contracts are neither void, unenforceable, nor enjoinable for the reasons raised in the consolidated lawsuits by the parties adverse to the Palo Verde participants (the "Adverse Parties"). The Adverse Parties have appealed that decision to the Arizona Court of Appeals. APS and certain Palo Verde participants, including the Company, have cross-appealed. On December 17, 1986, the consolidated appeals and cross-appeals were transferred to the Arizona Supreme Court, and oral argument was heard on February 20, 1987. Subsequently, three of the five Supreme Court Justices removed themselves from the case, and a rehearing of oral argument occurred on February 16, 1988.

On November 22, 1985, several municipalities which are parties to the primary effluent contract filed an action in Maricopa County Superior Court against certain of the Adverse Parties seeking a declaration that the primary effluent contract is valid notwithstanding claims asserted by those Adverse Parties that approval of the effluent contract exceeded the municipalities' legal authority and that the contract violates the laws and public policy of Arizona. APS was joined as an indispensable party. On July 29, 1986, the court declared that the primary effluent contract is valid and enforceable. The Adverse Parties appealed this decision, and on February 11, 1988, the Arizona Court of Appeals affirmed the lower court judgment. The Adverse Parties have petitioned the Arizona Supreme Court for review of the Court of Appeals decision.

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

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

Liability and Insurance Matters. The PVNGS participants have insurance for public liability payments resulting from nuclear energy hazards to the full limit ($720 million as of March 24, 1988) of liability under Federal law (such law being commonly referred to as the "Price- Anderson Act"). The maximum amount of private insurance of $720 million has been obtained, $160 million of which has been provided by commercial insurance carriers and the remainder of which ($560 million as of March 24, 1988) is provided through a secondary financial protection program using an industry-wide retrospective rating program. Under this retrospective program, the Palo Verde participants, collectively, could be assessed deferred premium charges of up to $5 million (the Company's 15.8% share of which would be approximately $790,000) for each Palo Verde reactor in the event the total liability arising from any nuclear incident involving any licensed facility in the nation exceeds $160 million. In the event of more than one incident, the potential $5 million assessment would apply to each incident, subject to a maximum annual assessment of $10 million (the Company's share of which would be

approximately $1.58 million) for each Palo Verde reactor for all incidents. The insureds under the liability insurance include PVNGS participants and "any other person or organization with respect to his legal responsibility for damage caused by the nuclear energy hazard."

Since January 1987, workers compensation claims of the Palo Verde participants have been provided for through a self-insured program of the Project Manager. As of January 1, 1988, the $160 million policy of commercial liability insurance was amended to exclude from coverage any claims of "new workers," defined as those persons who first became engaged in nuclear-related employment at any domestic nuclear facility on or after January 1, 1988. To replace this recently excluded coverage, commercial insurers have offered, and the Palo Verde participants have obtained, insurance providing coverage against new workers' claims under an industry-wide master workers policy up to an aggregate policy limit of $160 million for payment of all such claims. Such aggregate limit applies to payments of claims and costs made on behalf of all insureds under the master workers policy. Such coverage does not apply to claims under workers' compensation statutes nor to claims by the employees of any insured against such insured. On January 1, 1998, coverage for claims of all workers who are not "new workers" will be excluded from the commercial insurance described above and will be provided under the master workers policy.

In addition to the foregoing insurance, the Palo Verde participants maintain suppliers and transporters nuclear liability insurance in the amount of $160 million which covers potential liability arising out of certain nuclear risks associated with Palo Verde activities conducted, or radioactive materials located, off the Palo Verde site.

The PVNGS participants maintain "all risk" (including nuclear hazards) insurance for damage to, and decontamination of, property at Palo Verde in the aggregate amount of $1.525 billion as of January 1, 1988, a substantial portion of which must first be applied to decontamination. The Company has also secured insurance against the increased cost of generation or purchased power resulting from an accidental outage of a nuclear unit, which, after a 26-week deductible period, will pay up to $1,848,458 per week for Unit 1, $1,818,796 per week for Unit 2 and $1,689,500 per week for Unit 3, for 52 weeks, and up to 50% of such amounts for an additional 52 weeks. In the event that an incident affects more than one unit, the coverage is reduced by 20% for each additional affected unit (i.e., two units simultaneously out of service results in 80% of single unit recovery and three units simultaneously out of service results in 60% of single unit recovery).

In addition to the above-described policies of insurance, the PVNGS participants are parties to an indemnity agreement with the NRC containing an undertaking by the NRC to indemnify the PVNGS participants against public liability from nuclear incidents in excess of the level of financial protection required of the Palo Verde participants but not in excess of $560 million. The indemnity agreement is not currently operative and will remain inoperative unless or until the level of financial protection (i.e., the aggregate amount of primary and secondary levels of liability protection) required of the PVNGS participants falls below $560 million.

The provisions of the Price-Anderson Act relating to the authority of the NRC to enter into new indemnity agreements with licensees of nuclear power plants, for which construction permits were not issued prior to August 1, 1987, expired on August 1, 1987. However, the Comptroller General of the United States has delivered an opinion stating that, until new legislation is adopted, the provisions of the Price-Anderson Act relating to the retrospective rating plan and the limitation of liability will continue to be applicable to nuclear power plants licensed for construction or operation prior to that date. The 100th Congress has considered extension of the expired provisions of the Price-Anderson Act as well as amendment or elimination of other provisions thereof. In its session which ended in December 1987, the United States House of Representatives passed a bill which, if enacted into law, would extend the expired provisions to August 1, 1997 and would increase the maximum liability for each nuclear incident to approximately $7.6 billion (assuming 112 licensed nuclear reactors) for all persons who may be liable in respect thereof, subject to increase (i) to reflect the effects of inflation and (ii) as additional nuclear reactors are licensed for operation. This potential liability would be

covered by the primary liability insurance in the amount of $160 million, increased assessments under the retrospective rating program, and potential surcharges. Assessments under the retrospective rating plan with respect to each nuclear incident would be increased to $63 million per nuclear reactor, subject to an annual limit per reactor of $10 million per nuclear incident. In the event that the funds provided by the retrospective rating plan were insufficient to satisfy public liability claims and legal costs, the licensees, collectively, of each nuclear reactor would be subject to a surcharge of up to 5% of the $63 milllion retrospective premium to satisfy such claims and costs, which surcharge would be subject to increase to reflect the effects of inflation. Under these provisions, the Company's maximum potential assessment under the retrospective rating plan (based on its present interest in PVNGS and assuming (x) that the other participants in PVNGS were to contribute their proportionate share of potential assessments and (y) the absence of any increase to reflect the effects of inflation) would increase to approximately $29.9 million per incident, but would be limited to $4.7 million per year for each nuclear incident. However, such assessments could be increased by the possible surcharge, although the Company's aggregate share of such surcharge would, on the basis of the assumptions contained in the preceding sentence, be limited to approximately $1.5 million, regardless of whether such sum were to be payable in one year or over a period of years. On March 18, 1988, the United States Senate passed legislation which is substantially similar to the legislation passed by the House of Representatives. Although the Company cannot predict whether the legislation passed by the House and Senate will be reconciled on an expedited basis, the Company believes that final legislation containing terms substantially similar to those described in this paragraph will be enacted into law in the near future, which would substantially increase the Company's potential assessment in the event of a nuclear incident.

Certain of the expected changes in the Price-Anderson Act could permit the equity investors in the Unit 2 sale and leaseback transactions to declare a deemed loss event under the related leases. However, such legislation includes a provision to the effect that a lessor in a bona fide lease of a nuclear generating facility will not be liable by reason of its interest as lessor for any legal liability arising from a nuclear incident, unless such lessor is in actual possession and control of such facility at the time of the incident. The Company believes that such provision will make declaration by any such equity investor of a deemed loss event less likely. Under the leases pertaining to Palo Verde Unit 3, certain amendments to or replacements of the Price-Anderson Act or the Atomic Energy Act have been specifically deemed to be "safe harbor changes" which would not result in the occurrence of a deemed loss event. The bills passed by the House and the Senate should, in the Company's view, qualify as "safe harbor changes", although, because neither the content of any legislation that may finally become law nor the reaction which the equity investors may have to such legislation can be predicted with certainty, there can be no assurance that final legislation will constitute a "safe harbor."

In addition, certain provisions in the Unit 2 sale and leaseback transaction leases purport to require the Company to carry and maintain, or to cause the Palo Verde operating agent to carry and maintain, specified insurance coverage and endorsements with respect to the leased Unit 2 interests. The Company has been informed that one or more of the endorsements that may be required by such leases are not currently available. As a result, the lessors may be entitled to declare a deemed loss event under their respective leases.

If a deemed loss event were so declared, the Company would be obligated to pay a cash amount to such equity investor which could, due primarily to certain tax consequences, exceed such equity investor's unrecovered equity investment in respect of its undivided interest in Unit 2. See Note D of Notes to Consolidated Financial Statements. If an equity investor were to declare a deemed loss event, the Company would also be required to use its best efforts to assume the debt issued by the lessor in connection with the Unit 2 sale and leaseback transactions. Failure to make the required payment could, under certain circumstances, constitute an event of default under the Unit 3 leases. The Company is unable to predict whether any of such equity investors would declare a deemed loss event even if it were entitled to do so.

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

Environmental Matters

The Company's operations are subject to stringent environmental protection measures imposed under federal and state laws and regulations, some of which have required substantial expenditures for pollution control technology. The Four Corners Plant has been particularly affected by such environmental protection measures, and installation of costly retrofit particulate and sulfur dioxide control equipment has been required at an approximate cost since 1977 to the Company of $34,000,000. It has also been necessary to obtain variances or stipulations for certain aspects of operations at Four Corners. APS, as Operating Agent at Four Corners, has over the past several years obtained variances from the New Mexico Environmental Improvement Division (the "NMEID") relating to the emission of nitrogen oxides for Units 4 and 5 at Four Corners. The most recent variance was granted on December 18, 1987 in order to allow adequate time for the installation of additional equipment intended to achieve compliance with existing emissions limitations without adverse operational impact. The variance was granted through September 30, 1989 for Unit 4, and September 30, 1991 for Unit 5. The total cost for the retrofit of the new burners and associated modifications for Units 4 and 5 is estimated to be approximately $30,000,000, of which the Company's share would be approximately $2,100,000.

The Federal Clean Air Act Amendments of 1977 may require installation of "the best available retrofit technology" on sources that impact visibility in certain federally protected areas where visibility is an important attribute. The Four Corners Plant is one such source. The installation is to occur as expeditiously as practicable, and in any event, within approximately five years after revision of the applicable state implementation plan. The applicable regulations have not been finalized, and, as a result, the full significance and cost of the visibility provisions to the Four Corners Plant cannot be predicted.

Problems of interpreting and complying with the various measures described above, and the evolution of new measures, require continuing involvement of the Company in proceedings before the United States Congress, state legislatures, federal and state regulatory agencies and the courts. The Company cannot accurately predict the financial and operating impacts which may result from revisions to existing laws.

Energy Sources

General

Since 1983, the Company's energy mix has generally consisted of natural gas, coal and purchased power. Beginning in 1986, uranium became a part of the Company's energy mix, decreasing the importance of purchased power. This, in combination with lower natural gas costs, resulted in decreases in the Company's average yearly system energy cost. The following table lists the percentage contribution of coal, gas, uranium, and purchased power to the total energy mix of the Company and the average cost to the Company in cents per KWH.

	Coal		Gas		Uranium		Purchased Power	
	Percent of Energy Mix	Average Cost	Percent of Energy Mix	Average Cost	Percent of Energy Mix	Average Cost	Percent of Energy Mix	Average Cost
1983	18%	.77¢	44%	4.23¢	—%	—¢	38%	2.30¢
1984	16	.83	46	4.00	—	—	38	2.64
1985	11	1.02	28	3.81	—	—	61	2.80
1986	13	1.01	30	2.36	7	.98	50°	2.30
1987	14	1.04	32	2.10	12	.96	42°	2.04

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

For a discussion of the recovery by the Company of its fuel costs, either in base rates or through fuel adjustment clauses, see Note A of Notes to Consolidated Financial Statements.

The Company's El Paso generating units are subject to the requirements of the Fuel Use Act, as amended (the "FUA"). Under such Act, the Company may continue to burn natural gas in its existing generating units for the life of the units, subject to compliance with a DOE approved energy conservation plan filed by the Company in 1982. In early 1988, the Company will file its final update to the Conservation Plan. In the future, under Section 712 of the FUA, the Company will be required to file annual statements stating that it is in compliance with its conservation plan. The Company will continue its conservation programs in the areas of customer assistance, public information and operating efficiency.

Natural Gas

The Company is supplied with natural gas from both interstate and intrastate pipeline systems. The interstate pipeline owned by EPNG is interconnected with the Company's Rio Grande Station. El Paso Gas Transportation Company supplies both intrastate and spot natural gas to the Company's Newman and Copper Stations.

In 1987, approximately 50% of the Company's interstate natural gas requirements consisted of contract gas supplied by EPNG. The remaining 50% was spot natural gas supplied by El Paso Gas Marketing, a subsidiary of EPNG. In December 1986, the Company gave EPNG its termination notice of one year under the existing contract and began negotiating a new contract gas agreement with EPNG. It is expected that the new agreement will allow the Company to optimize its natural gas purchases through a mix of contract and spot gas and, therefore, provide the Company the flexibility to acquire the least expensive natural gas supply. In 1988, the Company expects the majority of its natural gas requirements at the Rio Grande Station to be met through purchases of spot natural gas.

The intrastate natural gas requirements at Copper and Newman are supplied pursuant to the intrastate natural gas contract with El Paso Hydrocarbons and transported by its subsidiary El Paso Gas Transportation Company. This contract was amended in 1986, lowering the Company's take-or-pay requirements, resulting in greater flexibility and allowing maximization of the use of inexpensive economy purchased power and generation from Palo Verde. In addition, interstate natural gas can be supplied to Newman Units 1, 2 and 3 which allows for a back up natural gas supply when operational constraints on the intrastate gas system dictate the need for an alternate fuel supply.

During 1987, the Company experienced only slight supply curtailments on its interstate system due to the shortage of natural gas caused by severe winter weather conditions in various parts of the nation. The impacts of the curtailments were minimal because the Company was able to shift load to other generating plants or purchase economy power. The Company does not expect any significant curtailments during 1988 with respect to either interstate or intrastate gas supplies.

Coal

APS, the Operating Agent for the Four Corners Plant, purchases coal to fuel such plant from coal suppliers with long-term leases of coal reserves owned by the Tribe. Such coal supplier is currently disputing the Tribe's ability to assess certain taxes against it. Any collection from the coal supplier of these taxes would increase the Company's coal costs in an amount that the Company does not deem material.

The Company believes that sufficient reserves of low sulfur coal (the sulfur content of which is currently running 0.8%) have been committed to the two units of Four Corners in which the Company has an undivided interest to continue operating such units for their useful lives. Prices paid for coal supplied from reserves dedicated under the existing contract have been stable, although applicable

contract clauses permit escalations under certain conditions. In addition, major price increases from time to time could result from contract renegotiation.

The Four Corners Participants (the "Participants") reopened the coal supply contract with the supplier in February 1986 for the purpose of seeking a downward adjustment in the price of coal delivered to the Four Corners Plant. In the subsequent negotiations, the supplier requested a price increase. Because of the price dispute, the Participants filed a complaint for declaratory relief and damages against the supplier in November 1987 in the Maricopa County Superior Court. While the Participants are requesting that the court declare that they are entitled to a reduction in the price paid for coal, the outcome of the matter cannot be predicted with certainty. The Company believes, but has no assurance, that any increased costs incurred as a result of contract renegotiation will be recoverable either through fuel adjustment clauses or as a recovery of operating expenses in subsequent rate proceedings.

Nuclear Fuel

The fuel cycle for the Palo Verde Station is comprised of the following stages: (1) the mining and milling of uranium ore to produce uranium concentrates; (2) the conversion of uranium concentrates to uranium hexafluoride; (3) the enrichment of uranium hexafluoride; (4) the fabrication of fuel assemblies; (5) the utilization of fuel assemblies in reactors; and (6) the storage of spent fuel and the disposal thereof. Arrangements have been made to obtain quantities of uranium concentrate anticipated to be sufficient, if certain contract options are exercised, to meet operational requirements through 1998. Spot purchases on the open market will be made as appropriate in lieu of any uranium which might be obtained pursuant to the contract options. The Palo Verde participants have also contracted for a significant portion of the conversion services required through 1992. In addition, existing contracts will provide fuel assembly fabrication services for at least ten years from the operation date of each Palo Verde unit and, if options are exercised, for approximately twelve additional years.

The participants in Palo Verde, including the Company, have an enrichment services contract with DOE that obligates DOE to furnish the enrichment services required for the operation of the three Palo Verde units over a term expiring in November 2014. In September 1985, the United States District Court for the District of Colorado held that the form of the contract used by DOE in its negotiations with utilities, including the contract with the Palo Verde participants, is null and void because it was not submitted to Congress for approval. The district court also held that DOE must restrict the enrichment of foreign uranium when the domestic uranium industry is not viable. DOE appealed and, on July 20, 1987, the United States Court of Appeals for the Tenth Circuit affirmed the district court's decision regarding the enrichment of foreign uranium, but ordered that the case be remanded to the district court for a determination of whether the plaintiff in the action has standing to challenge the form of the contract. Due to the unresolved standing issue, no decision was made as to the validity of the form of the utility services contract. The decision of the court of appeals regarding the enrichment of foreign uranium has been appealed by DOE to, and is currently pending before, the United States Supreme Court. DOE has continued to honor its commitments under its contracts while awaiting a decision in the case. Regardless of the outcome of the case, the Company believes that the Palo Verde participants will be able to contract with DOE or other sources for adequate enrichment services.

Spent fuel storage facilities at Palo Verde have sufficient capacity to store all fuel expected to be discharged from normal operation of all of the Palo Verde units through at least the year 2005. Pursuant to the Nuclear Waste Policy Act of 1982 (the "Act"), DOE is obligated to accept and dispose of all spent nuclear fuel and other high-level radioactive wastes generated by all domestic power reactors. The NRC, pursuant to the Act, also requires all operators of nuclear power reactors to enter into spent fuel disposal contracts with DOE. APS, as Project Manager, on behalf of itself and the other Palo Verde participants, including the Company, has executed a spent fuel disposal contract with DOE. The Act also obligates DOE to develop the facilities necessary for the disposal of all spent fuel

generated and to be generated by domestic power reactors and to have the first such facility in operation by 1998 under prescribed procedures. In December 1987, Congress passed the Nuclear Waste Policy Amendments Act of 1987, substantially changing the Act by, among other things, decreasing to one the number of sites to be initially considered for disposal facilities. DOE is currently assessing the impact of this legislation on the waste program implementation schedule, and a DOE report to Congress with a new schedule is due sometime during 1988.

Pursuant to the Participation Agreement among the participants in the Palo Verde Station, the Company has an undivided interest in nuclear fuel purchased and to be purchased in connection with the operation of Units 1, 2 and 3 of the Station. The Company has a nuclear fuel purchase commitment with an independent trust. The trust's financing is based upon a letter of credit with a three-year term which is annually extended by one year if notice to the contrary is not given to the trust by the issuing bank. The letter of credit is currently scheduled to expire on January 8, 1991. The trust purchases nuclear fuel and incurs all costs in connection with the acquisition of the fuel and related materials for use by the Company at Palo Verde. The Company has the option of either purchasing the fuel from the trust or purchasing the heat generated by the fuel at prices established to reimburse the trust for all the costs incurred in connection with acquisition of the fuel. The Company is required to elect one of these options for each batch of nuclear fuel. The Company has elected the heat purchase option as the basis for payment for the first fuel loads for Palo Verde Units 1, 2 and 3 and for the first fuel reloading at Palo Verde Unit 1 and presently intends to elect the heat purchase option as the basis for payment for future fuel reloadings. Quarterly heat payments at the established prices began in the first quarter of 1986 for Palo Verde Unit 1, the first quarter of 1987 for Unit 2 and will begin in the second quarter of 1988 for Unit 3. At December 31, 1987, the aggregate investment of the trust in such nuclear fuel and related materials was approximately $106,500,000, including approximately $73,800,000 for fuel loaded at Palo Verde Units 1, 2 and 3.

Executive Officers of the Registrant

Name	Age	Current Position and Business Experience
Evern R. Wall	55	Chairman of the Board since December 1980; President from May 1976 to January 1988; Chief Executive Officer since May 1976; and Member of the Executive Committee of the Board of Directors.
David H. Wiggs, Jr.	40	President, Chief Operating Officer and a Director since January 1988 and for more than 5 years prior thereto served as the Company's chief regulatory attorney and a partner with Kemp, Smith, Duncan & Hammond, general counsel to the Company.
Charles Mais	56	Senior Vice President since June 1986; Vice President from December 1978 to June 1986.
Ignacio R. Troncoso	41	Senior Vice President since January 1988; Vice President from May 1982 to January 1988.
William J. Johnson	46	Senior Vice President since January 1988; Vice President from May 1984 to January 1988; Treasurer from December 1986 to February 1988; Chief Financial Officer since December 1986 and Controller from May 1978 to December 1986.
William W. Royer	43	Senior Vice President since January 1988; Vice President from December 1985 to January 1988; Treasurer from December 1983 to December 1986 and General Counsel from March 1981 to February 1988.
Joseph E. Wasiak	56	Senior Vice President since January 1988; Vice President from February 1986 to January 1988; Assistant Vice President from May 1984 to February 1986 and for more than 5 years prior thereto served in various managerial and supervisory capacities with the Company.
Lawrence M. Downum, Jr.	49	Vice President since December 1983 and for more than five years prior thereto served in various managerial and supervisory capacities with the Company.
James P. Maloney	56	Vice President since February 1986; Assistant to the President from October 1985 to February 1986; Commanding General of Fort Bliss, Texas from June 1982 to August 1985.
Robert L. Corbin	57	Vice President since December 1986; Assistant Vice President and Assistant Secretary from May 1984 to December 1986 and for more than 5 years prior thereto served as Assistant Treasurer, Assistant Secretary and in various managerial and supervisory capacities with the Company.
Gary R. Hedrick	33	Treasurer since February 1988; Vice President, Treasurer and Chief Financial Officer of PasoTex Corporation from December 1986 to February 1988; Treasurer of Franklin Land & Resources since December 1986, and for more than 5 years prior thereto served in various managerial and supervisory capacities with the Company.
Gordon M. Heggem	61	Controller since May 1987 and for more than 5 years prior thereto Manager of General Accounting.
Theta S. Fields	62	Secretary since 1977 and Assistant to the Chairman of the Board since June 1986.
Eduardo A. Rodriguez	32	General Counsel since February 1988; Assistant General Counsel from December 1984 to February 1988; Assistant Secretary since June 1986 and Staff Counsel from November 1981 to December 1984.
Billye E. Bostic	57	President of PasoTex, the Company's investment subsidiary, since December 1986; Vice President of FL&R, a subsidiary of the Company, since April 1982; Executive Vice President of the Company from May 1982 until December 1986.

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

Non-Utility Operations

In addition to its electric utility operations, the Company has various subsidiaries which engage in unregulated, non-utility businesses. The Company engages in its non-utility operations through its wholly-owned subsidiary, FL&R, and through PasoTex, which is 65% owned by FL&R and 35% owned by the Company.

PasoTex

During 1987, the Company transferred approximately $110 million of the proceeds from the Unit 2 sale and leaseback transactions to PasoTex, which was established for the purpose of investing such funds to earn a return to offset the portion of the Unit 2 lease payments not recoverable through rates (See Note D of Notes to Consolidated Financial Statements). PasoTex was established and operates pursuant to the approval of the Company's general diversification plan by the New Mexico Commission in November 1987. Under the order approving the plan, the Company can invest up to $120 million through PasoTex, the funding of such investment to come from the net after-tax gain from the Unit 2 sale and leaseback.

PasoTex has invested approximately $65 million of its funds in certain non-publicly held preferred stocks and has invested the balance of its funds principally for the acquisition of controlling or complete ownership interests in certain entities, including a speciality steel products manufacturer, a lamp manufacturer, a furniture manufacturer and a marketer of oil country tubular goods. When economically feasible, PasoTex will move certain operations of its subsidiaries to the Company's service area to provide new jobs and economic development, thereby broadening the Company's customer base. To a lesser extent, PasoTex has invested in certain financing transactions.

FL&R

FL&R borrows independently from third parties, without recourse to the Company (except for certain borrowings pursuant to the Company's nuclear fuel and fuel oil financing arrangements) for the purposes of its various investments and activities. FL&R's major investments include a luxury hotel and two office buildings (one of which is leased to the Company and the other of which was 86% leased at December 31, 1987), all located in downtown El Paso. FL&R has also invested in certain partnerships for the leasing of assets to third parties, preferred stocks, and other real estate. Substantially all of the assets of FL&R have been pledged to secure its various borrowings.

Financial Information

For financial information regarding the Company's non-utility operations, see Note N of Notes to Consolidated Financial Statements.

Utility Operating Statistics

	December 31, 1987	1986	1985
Utility Operating Revenues (In thousands):			
Retail:			
Residential	$ 103,761	$ 103,428	$ 108,289
Commercial and industrial, small	95,766	98,543	104,679
Commercial and industrial, large	32,976	37,821	45,325
Sales to public authorities	51,493	50,872	53,993
Provision for refund	(3,019)	(10,006)	—
Other	1,573	2,149	2,324
	282,550	282,807	314,610
Wholesale:			
Sales for resale	55,242	35,302	24,981
Total utility operating revenues	$ 337,792	$ 318,109	$ 339,591
Number of customers (End of year):			
Residential	204,102	198,002	191,248
Commercial and industrial, small	20,582	20,115	19,349
Commercial and industrial, large	41	39	41
Other	2,509	2,309	2,263
Total	227,234	220,465	212,901
Average annual use and revenue per residential customer:			
KWH	5,846	5,719	5,735
Revenue	$ 514.10	$ 530.86	$ 575.37
Average revenue per KWH:			
Residential	8.79¢	9.28¢	10.03¢
Commercial and industrial, small	7.28	7.78	8.70
Commercial and industrial, large	5.19	5.74	6.51
Energy supplied, net, KWH (In thousands):			
Generated	3,186,967	2,422,514	1,823,946
Purchased and interchanged	2,264,955	2,437,875	2,838,904
Total	5,451,922	4,860,389	4,662,850
Energy sales, KWH (In thousands):			
Retail:			
Residential	1,179,812	1,114,177	1,079,432
Commercial and industrial, small	1,316,198	1,267,129	1,202,938
Commercial and industrial, large	635,448	658,521	696,662
Sales to public authorities	860,852	809,619	786,983
	3,992,310	3,849,446	3,766,015
Wholesale:			
Sales for resale	1,087,444	641,858	511,517
Total sales	5,079,754	4,491,304	4,277,532
Losses and company use	372,168	369,085	385,318
Total	5,451,922	4,860,389	4,662,850
Native system:			
Peak load, KW	820,000	790,000	778,000
Net generating capacity for peak, KW	1,297,000	1,103,000	989,000
Load factor	61.5%	61.6%	60.8%
Total system:			
Peak load, KW	975,000	938,000	877,000
Net generating capacity for peak, KW	1,297,000	1,103,000	989,000
Load factor	64.4%	59.9%	61.3%

Item 2. Properties

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

Item 3. Legal Proceedings

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

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

Not applicable.

PART II

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

The Company's common stock is traded in the over-the-counter market and quoted on the NASDAQ National Market System. The high and low sale prices for the Company's common stock, as reported by NASDAQ, and the quarterly dividends per share paid by the Company, for the periods during 1986 and 1987 indicated below, were as follows:

	Sale Price		
	High	Low	Dividends
1986			
First Quarter	18	15⅛	$0.38
Second Quarter	18½	13½	0.38
Third Quarter	19¾	15⅞	0.38
Fourth Quarter	19¼	16¼	0.38
1987			
First Quarter	21⅝	18¾	0.38
Second Quarter	18¾	16½	0.38
Third Quarter	17½	15¼	0.38
Fourth Quarter	16⅞	13⅛	0.38

At February 26, 1988, there were 46,136 holders of record of the Company's common stock.

The Company's Restated Articles of Incorporation and the First Mortgage Indenture and certain of the supplemental indentures relating to the various series of First Mortgage Bonds contain restrictions as to the payment of dividends on the common stock of the Company and as to the purchase or retirement of capital stock of the Company. At December 31, 1987, the retained earnings available for dividends on the common stock under the most restrictive of those provisions was approximately $175,800,000.

The Company has paid quarterly dividends on its common stock without interruption since distribution of the common stock to the public in 1947 (40 years). The current indicated annual dividend rate is $1.52 per share. The Company intends to continue to pay quarterly dividends on its common stock, but future dividends will depend upon earnings, cash flow, the financial condition of the Company and other factors. See "Company Conditions," "Utility Construction Program and

Financing Capability — Future Cash Requirements" and "Restrictions on Financing Capabilities" and Management's Discussion and Analysis of Financial Condition and Results of Operations.

Item 6. Selected Financial Data

As of and for the years ended December 31:

	1987	1986	1985	1984	1983
		(In thousands except per share data)			
Operating revenues:					
Utility	$ 337,792	$ 318,109	$ 339,591	$ 329,015	$ 302,443
Non-utility	112,324	3,457	6,687	5,553	5,916
Total	$ 450,116	$ 321,566	$ 346,278	$ 334,568	$ 308,359
Net income	$ 45,008	$ 95,614	$ 113,071	$ 108,286	$ 87,261
Net income per weighted average shares of common stock	.91	2.32	2.88	2.88	2.48
Dividends declared per share of common stock	1.52	1.52	1.49	1.43	1.37
Total assets	2,275,573	2,194,418	1,919,060	1,690,109	1,393,283
Long-term, financing and capital lease obligations and preferred stock — redemption required	888,328	947,631	971,228	803,577	591,563

See Note A of Notes to Consolidated Financial Statements for a discussion of change in accounting method.

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

Liquidity and Capital Resources

The Company's liquidity is a function of the rates it is allowed to charge to its customers for the sale of electricity, its ability to finance capital expenditures as well as the effects of rate increases which are phased-in, and the ability of its unregulated, non-utility subsidiaries to generate cash from their operations sufficient to meet their needs as well as to pay dividends to the Company to fund the lease payments related to Palo Verde which are not recovered from ratepayers. As a result of the substantial completion of the Palo Verde construction program, the Company's cash construction requirements will decrease substantially as compared to previous years, and for the period 1988-1991, such construction requirements aggregate approximately $185 million. However, substantial amounts of long-term debt and preferred stock (aggregating $285 million) will mature or require redemption during such period. The Company retired $250 million of first mortgage bonds and secured long-term notes during 1986, 1987 and early 1988. A portion of the proceeds from the Palo Verde sales and leaseback transactions have been and will be utilized, during the 1988-1991 time period, for the Company's construction program and for debt maturities and preferred stock redemptions. The balance of the proceeds, together with cash generated from operations and short-term borrowings are expected to provide the balance of the Company's cash requirements, including common and preferred dividends, during the 1988-1991 period. Neither the Company nor its subsidiaries currently anticipates the need for any significant additional long-term financing until after 1991. See "Company Conditions", "Rates and Regulation", and "Utility Construction Program and Financing Capability."

Results of Operations

Although utility operating revenues increased approximately $19,700,000 and utility operating income increased approximately $6,600,000 in 1987, consolidated net income decreased approximately

$50,600,000, principally due to the $24,400,000 after-tax non-cash write-off which the Company recorded in connection with the Texas stipulation (see "Rates and Regulation — Rate Matters — Texas") and the realized and unrealized losses of approximately $17,600,000 sustained in 1987 on the Company's investments in marketable securities, primarily in connection with the stock market break on October 19, 1987.

The Company believes that the principal factors which will affect the future financial position and results of operations of the Company will be the attainment of the Company's projected increases in load growth (demand), the inclusion in rate base of Unit 3 in the Texas jurisdiction upon completion of the required transmission line, currently scheduled for the end of 1989, and the ability of the Company to finance the effects of its Texas and New Mexico rate moderation plans, which, in part, depends upon the ability of the Company's unregulated operations to earn an adequate rate of return and level of cash flow.

Utility

The primary reasons for increases (decreases) in results of operations for the year ended December 31, 1987 over the year ended December 31, 1986 and the year ended December 31, 1986 over the year ended December 31, 1985 are as follows (in thousands):

	1987 over 1986	1986 over 1985
Operating Revenues:		
Base:		
Volume	$28,414	$ 10,199
Rates and/or change in sales mix	(4,777)	3,298
	23,637	13,497
Fuel:		
Recovery of fuel and purchased and interchanged power cost and other	(3,954)	(34,979)
Total	$19,683	$(21,482)

Base revenues increased for 1987 over 1986 due to an increase in KWH sales (volume), which was partially offset by a decrease in base rates for Texas customers and a change in sales mix. Base revenues increased for 1986 over 1985 due to increased KWH sales (volume), an increase in base rates for FERC and New Mexico jurisdictions and a change in sales mix.

Fuel revenues decreased for 1987 over 1986 and 1986 over 1985 due to a decrease in the average cost of fuel and purchased and interchanged power recovered.

	1987 over 1986	1986 over 1985
Fuel and Purchased and Interchanged Power Expense:		
Fuel:		
Volume and average cost of fuel	$ 7,012	$ (7,579)
Purchased and interchanged power:		
Volume	(4,051)	(12,748)
Cost	(5,818)	(10,687)
	(9,869)	(23,435)
Total	$(2,857)	$(31,014)

The increase in fuel expense in 1987 compared to 1986 was due to an increase in volume of nuclear fuel and natural gas consumed. The increase in 1987 was offset in part by a decrease in the average cost of natural gas. The decrease in fuel expense in 1986 compared to 1985 was due to a decrease in the

average cost of natural gas offset by a decrease in fuel refunds and an increase in volume of fuel consumed.

Purchased and interchanged power decreased in 1987 compared to 1986 and 1986 compared to 1985 due to decreased purchases from other utilities as a result of increased power available from Palo Verde partially offset by the major portion of Palo Verde power being accounted for as purchased power expense. Increased sales of electricity to other utilities also contributed to the decrease in 1987 compared to 1986.

	1987 over 1986	1986 over 1985
Other Operations and Maintenance Expenses:		
Palo Verde costs	$ 48,533	$ 17,724
Palo Verde costs deferred	(37,713)	(12,584)
	10,820	5,140
Other	11,666	2,807
Total	$ 22,486	$ 7,947

Other operations and maintenance expenses increased in 1987 over 1986 and 1986 over 1985 due to expensing of Palo Verde costs resulting from placing in commercial operation Unit 1 and common facilities in February 1986 and Unit 2 in September 1986.

The increase in Palo Verde costs deferred in 1987 over 1986 was due to deferring the Texas and New Mexico jurisdictional portions of Palo Verde Units 1 and 2 and related common facilities. For 1986 over 1985 the increase in Palo Verde costs deferred was due principally to deferring the costs of the Texas jurisdictional portion of Unit 1 and related common facilities with no comparable deferral in 1985. See Note C of Notes to Consolidated Financial Statements.

Depreciation and Amortization Expense:

Depreciation increased in 1987 over 1986 and in 1986 over 1985 due to depreciating a portion of Palo Verde Unit 1 and Common Plant beginning in March 1986 and a portion of Palo Verde Unit 2 beginning in October 1986.

	1987 over 1986	1986 over 1985
AFUDC:		
Cumulative construction balance and other	$(29,483)	$(35,181)
Deferral of Palo Verde costs	(3,972)	23,995
Total	$(33,455)	$(11,186)

AFUDC decreased in 1987 compared to 1986 due to decreased cumulative construction and Palo Verde deferred cost balances accruing AFUDC due to the sale of Palo Verde Unit 2 in the second half of 1986. AFUDC decreased in 1986 compared to 1985 due to a decreased cumulative construction balance resulting from the sale of Palo Verde Unit 2 in 1986 and the placing in service of FERC and New Mexico jurisdictional portions of Palo Verde Unit 1 and Common Plant. The decrease was partially offset by AFUDC accrued on Palo Verde deferred costs and decreased CWIP included in rate base.

Consolidated

Investment Income:

Investment income decreased in 1987 compared to 1986 due to realized and unrealized losses incurred on the Company's investments in marketable securities. Investment income in 1986 increased

over 1985 due to investment income earned on the invested portion of the proceeds from the sale and leaseback of Palo Verde Unit 2.

Other Income, Net:

Other income, net, decreased in 1987 compared to 1986 due to the lease expense, net of gain amortization, related to the portion of the sale price of Palo Verde Unit 2 which is in excess of the book value of Unit 2.

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

Interest on long-term and financing and capital lease obligations decreased in 1987 over 1986 due principally to the early redemption of the 16.35% Series First Mortgage Bonds in May 1987. The decrease was partially offset by the interest on a financing obligation relating to one sale and leaseback transaction involving Palo Verde Unit 2. Interest on long-term and financing and capital lease obligations increased in 1986 over 1985 due to issuance of a floating rate note, pollution control bonds in 1985 and nuclear fuel lease obligations. This increase was partially offset by the early redemption of a floating rate note.

Other Interest Expense:

Other interest expense increased in 1987 over 1986 due to the interest on fuel overrecovery balances and accumulated provision for rate refund. Other interest expense increased in 1986 over 1985 due to an adjustment in 1985 reversing previously accrued incremental interest on short-term pollution control bonds.

Interest Capitalized and Deferred:

Interest capitalized decreased in 1987 over 1986 due to the completion in 1986 of a subsidiary's construction projects, on which interest was being capitalized during the construction period. The decrease was partially offset by interest deferred on a portion of a financing obligation relating to one sale and leaseback transaction involving Palo Verde Unit 2 and increased interest related to nuclear fuel lease obligations. For 1986 over 1985, interest capitalized increased due to an increased cumulative nuclear fuel lease balance and increased subsidiary's cumulative construction balance.

For further information with respect to results of operations of newly formed and acquired subsidiaries, see Note N of Notes to Consolidated Financial Statements.

See Note A of Notes to Consolidated Financial Statements for a discussion of SFAS No. 96 — Accounting for Income Taxes and Note B of Notes to Consolidated Financial Statements for a discussion of SFAS No. 92 — Regulated Enterprises — Accounting for Phase-in Plans.

Effects of Inflation:

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

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

Item 8. Financial Statements and Supplementary Data

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

The Shareholders and Board of Directors
El Paso Electric Company

We have examined the consolidated balance sheets of El Paso Electric Company and Subsidiaries as of December 31, 1987 and 1986, and the related consolidated statements of income, retained earnings and sources of funds invested in utility plant and other plant for each of the years in the three-year period ended December 31, 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 consolidated financial statements referred to above present fairly the consolidated financial position of El Paso Electric Company and Subsidiaries as of December 31, 1987 and 1986, and the results of their operations and the sources of funds invested in utility plant and other plant for each of the years in the three-year period ended December 31, 1987, in conformity with generally accepted accounting principles consistently applied during the period except for the change, with which we concur, in the method of accounting for unbilled revenues as described in note A of notes to consolidated financial statements.

PEAT MARWICK MAIN & CO.

El Paso, Texas
March 25, 1988

EL PASO ELECTRIC COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

ASSETS

	December 31, 1987	December 31, 1986
	(In thousands)	
Utility plant (Notes B, C and D):		
Electric plant in service	$1,089,804	$1,098,372
Less accumulated depreciation and amortization	171,708	149,728
Net plant in service	918,096	948,644
Construction work in progress	228,314	370,412
Nuclear fuel:		
Under capital leases net of amortization of $37,550,000 and $17,022,000, respectively	68,848	40,937
In process	—	26,500
Other	35	1,366
Net utility plant	1,215,293	1,387,859
Non-utility property, at cost net of accumulated depreciation	104,353	79,693
Investments (including escrowed and restricted cash investments of $217,000,000 in 1987) (Notes D and E)	324,873	81,155
Current assets:		
Cash and temporary investments (including escrowed cash investments of $173,300,000 in 1987) (Note D)	300,061	340,705
Other short-term investments (Note E)	15,602	172,969
Accounts receivable, principally trade, net	76,562	32,505
Inventories	50,888	14,161
Prepayments and other	34,595	25,065
Total current assets	477,708	585,405
Deferred charges and other assets:		
Palo Verde deferred costs (Notes B and C)	102,662	31,253
Other	50,684	29,053
Total deferred charges and other assets	153,346	60,306
Total assets	$2,275,573	$2,194,418

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

CAPITALIZATION AND LIABILITIES

	December 31, 1987	December 31, 1986
	(In thousands)	
Capitalization (Notes F, G and H):		
Common stock, no par value, 40,000,000 shares authorized. Issued and outstanding 34,972,180 and 35,510,138 shares, respectively	$ 334,299	$ 338,800
Additional paid-in capital	—	475
Retained earnings	239,320	264,016
Common stock equity	573,619	603,291
Preferred stock, cumulative, no par value, 2,000,000 shares authorized:		
Redemption required	110,610	115,710
Redemption not required	14,198	18,873
Long-term obligations	639,777	707,278
Financing and capital lease obligations (Note D)	137,941	124,643
Total capitalization	1,476,145	1,569,795
Current liabilities:		
Current maturities and planned redemptions of long-term and financing and capital lease obligations (Note H)	115,782	130,963
Notes payable and commercial paper (Note I)	174,176	10,806
Accounts payable, principally trade	37,299	7,441
Taxes accrued (Note J)	30,498	56,917
Interest accrued	22,458	23,412
Net overcollection of fuel revenues	5,636	15,843
Other	31,512	21,879
Total current liabilities	417,361	267,261
Deferred credits and other liabilities:		
Accumulated deferred income taxes (Note J)	40,180	72,755
Accumulated deferred investment tax credit (Note J)	131,540	122,185
Deferred gain on sales and leasebacks (Note D)	189,978	145,903
Provision for rate refunds and other (Note K)	20,369	16,519
Total deferred credits and other liabilities	382,067	357,362
Commitments and contingencies (Notes B, C, D, K and L)		
Total capitalization and liabilities	$2,275,573	$2,194,418

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

For the years ended December 31, 1987, 1986 and 1985

	1987	1986	1985
		(In thousands)	
Operating revenues:			
Utility	$337,792	$318,109	$339,591
Non-utility	112,324	3,457	6,687
	450,116	321,566	346,278
Operating expenses:			
Utility:			
Fuel	51,297	44,285	51,864
Purchased and interchanged power	46,199	56,068	79,503
	97,496	100,353	131,367
Other	69,913	49,973	43,521
Maintenance	14,246	11,700	10,205
Depreciation and amortization	21,162	19,186	14,755
Non-utility costs and expenses	115,546	5,471	1,216
Taxes:			
Federal income taxes (Note J)	10,097	25,920	37,709
Other	22,136	19,404	17,211
	350,596	232,007	255,984
Operating income	99,520	89,559	90,294
Other income (deductions):			
Allowance for equity funds used during construction and for deferred costs	31,941	49,595	57,349
Regulatory disallowance of plant costs (Note B)	(38,323)	—	—
Investment income:			
Realized and unrealized investment losses (Note E)	(17,644)	—	—
Other	31,133	14,223	9,813
Other, net	(7,479)	(1,953)	(1,037)
Federal income taxes applicable to other income (Note J):			
Regulatory disallowance of plant costs	13,937	—	—
Other	497	(5,690)	(4,037)
	14,062	56,175	62,088
Income before interest charges	113,582	145,734	152,382
Interest charges (credits):			
Interest on long-term and financing and capital lease obligations	87,615	91,853	82,246
Other interest	14,553	4,939	3,484
Interest capitalized and deferred	(6,896)	(8,413)	(4,728)
Allowance for borrowed funds used during construction and for deferred costs	(22,458)	(38,259)	(41,691)
	72,814	50,120	39,311
Income before cumulative effect of change in accounting method	40,768	95,614	113,071
Cumulative effect of change in accounting method (Note A)	4,240	—	—
Net income	45,008	95,614	113,071
Preferred stock dividend requirements	12,892	14,185	14,754
Net income applicable to common stock	$ 32,116	$ 81,429	$ 98,317
Net income per weighted average shares of common stock:			
Before cumulative effect of change in accounting method	$ 0.79	$ 2.32	$ 2.88
Cumulative effect of change in accounting method	0.12	—	—
Total	$ 0.91	$ 2.32	$ 2.88

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

For the years ended December 31, 1987, 1986 and 1985

	1987	1986	1985
		(In thousands)	
Retained earnings at beginning of year	$264,016	$236,042	$188,804
Add:			
Net income	45,008	95,614	113,071
	309,024	331,656	301,875
Deduct:			
Cash dividends:			
Preferred stock	12,892	14,185	14,754
Common stock	53,795	53,327	50,867
Capital stock expense	165	128	212
Purchase of Company common stock (Note F)	2,852	—	—
	69,704	67,640	65,833
Retained earnings at end of year	$239,320	$264,016	$236,042
Dividends declared per share of common stock	$ 1.52	$ 1.52	$ 1.49
Weighted average number of common shares outstanding	35,422,043	35,106,903	34,161,430

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARIES

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

For the years ended December 31, 1987, 1986 and 1985

	1987	1986	1985
		(In thousands)	
Funds provided from operations:			
Net income	$ 45,008	$ 95,614	$113,071
Principal items not requiring (providing) current funds:			
Depreciation and amortization	26,773	22,699	15,768
Deferred income taxes, net and investment tax credit, net	23,783	49,041	39,542
Allowance for equity funds used during construction and for deferred costs	(31,941)	(49,595)	(57,349)
Regulatory disallowance of plant costs	38,323	—	—
Other	8,306	6,139	1,689
Funds provided from operations before dividends	110,252	123,898	112,721
Less dividends	66,687	67,512	65,621
Funds provided from operations after dividends	43,565	56,386	47,100
Funds provided from (used for) financing:			
Sales and issuances of securities:			
Common stock	1,482	12,767	15,370
Pollution control obligations, net of amounts on deposit with trustee and interest earned	(1,291)	(1,277)	64,025
Secured promissory notes	28,018	97,104	72,125
Unsecured promissory notes	—	—	45,000
Financing and capital lease obligations	49,588	92,601	55,160
Transfer of long-term obligations to short-term obligations	(116,887)	(119,322)	(21,814)
Redemption and repurchase of securities	(25,688)	(92,827)	(46,494)
Net increase (decrease) in short-term obligations*	148,189	81,908	(46,882)
Other	(11,642)	—	—
Net funds provided from financing	71,769	70,954	136,490
Other funds provided (used):			
Sales and leasebacks, net of related income taxes	203,018	527,362	—
Investments	(64,492)	(7,276)	5,321
Escrowed and restricted investments	(360,300)	(30,000)	—
Sale of nuclear fuel in process to trust	28,460	—	—
Non-utility acquisitions	(45,576)	—	—
Net (increase) decrease in working capital other than short-term obligations and escrowed investments	295,318	(444,880)	79,340
Other, net	(2,665)	11,764	868
Net other funds provided	53,763	56,970	85,529
Expenditures for utility plant, other plant and Palo Verde deferred costs	169,097	184,310	269,119
Allowance for equity funds used during construction and for deferred costs	31,941	49,595	57,349
Total funds invested	$201,038	$233,905	$326,468

* Short-term obligations are represented by the current maturities and planned redemptions of long-term and financing and capital lease obligations, commercial paper and notes payable.

See accompanying notes to consolidated financial statements.

A. Summary of Significant Accounting Policies

General

El Paso Electric Company (the Company) maintains its accounts in accordance with the Uniform System of Accounts prescribed for electric utilities by the FERC. The subsidiaries are not regulated companies.

The Company reports its regulated utility operations pursuant to SFAS No. 71 — Accounting for the Effects of Certain Types of Regulation. This pronouncement provides for specialized reporting and accounting requirements as they relate to specific transactions which are unique to the industry. SFAS No. 71 has been amended by SFAS No. 90 — Regulated Enterprises — Accounting for Abandonments and Disallowances of Plant Costs, issued in December 1986 and by SFAS No. 92 — Regulated Enterprises — Accounting for Phase-in Plans, issued in August 1987.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Utility Plant and Non-utility Property

Utility plant and non-utility property are stated at original cost, and depreciation is provided on a straight-line basis at annual rates which will amortize the undepreciated cost of depreciable property over the estimated remaining service lives. The average annual depreciation rate used by the Company for utility plant other than the Palo Verde Station was 3.43% in 1987 and 1986 and 3.28% in 1985. The average annual depreciation rate for the portions of the Palo Verde Station for which the Company is providing depreciation was 2.50% in 1987 and 1986.

The Company and its subsidiaries charge the cost of repairs and minor replacements to the appropriate operating expense accounts and capitalize the cost of renewals and betterments. The cost of depreciable utility plant retired or sold and the cost of removal, less salvage, are charged to accumulated depreciation.

The Company is amortizing nuclear fuel under the units of heat production method.

AFUDC

The Company's applicable regulatory bodies, FERC, the New Mexico Commission and the Texas Commission, generally provide for the capitalizing of AFUDC, which is defined as an amount which includes the net cost during a period of construction of borrowed funds used for construction purposes plus a reasonable rate on other funds when so used. While AFUDC results in an increase in the cost of utility plant under construction, with a corresponding increase in income, it is not current cash income. AFUDC, net of certain tax effects, is normally recovered in cash over the service life of utility plant in the form of increased revenue collected as a result of higher depreciation expense.

The Company records AFUDC during the construction period of utility plant and, in 1987 and 1986, additionally recorded AFUDC, pursuant to regulatory order, on utility plant placed in-service but pending regulatory treatment in rate base, as well as on operating costs deferred during the same period. See Note C of Notes to Consolidated Financial Statements.

The amount of AFUDC is determined by applying an accrual rate to the balance of certain CWIP and deferred costs. In this connection, the FERC has promulgated procedures for the computation (a prescribed formula) of the accrual rate. The weighted average accrual rate was 11.3%, 11.5% and 12.2% for 1987, 1986 and 1985, respectively. The Company compounds AFUDC on major construction

projects semiannually. Certain amounts of CWIP have been allowed in the Company's rate base or have been made the basis of extraordinary cash rate relief, and the appropriate amounts have been excluded from the CWIP balance used as a base for calculating AFUDC.

Change in Accounting Method

Prior to January 1, 1987, the Company recognized utility revenues when billed. To provide a better matching of the Company's revenues from kilowatt-hour sales with the related costs, effective January 1, 1987, the Company changed its method of accounting to record estimated revenues from sales of electricity for services provided subsequent to monthly billing cycle dates but prior to the end of the accounting period. The cumulative effect of this accounting change as of January 1, 1987, net of income taxes of $2,827,000, increased net income and net income per share for the year ended December 31, 1987 by $4,240,000 and $.12, respectively. The pro forma effect on net income for the year ended December 31, 1987 of applying the new method of accounting retroactively is not material.

Fuel Cost Adjustment Provisions

The Company's Texas and New Mexico retail customers are presently being billed under fixed fuel factors approved by the Texas Commission and the New Mexico Commission. The Texas fuel factor set in the Company's recently concluded rate case will remain in effect until the earlier of the Company's next general rate case or a Commission ordered fuel reconciliation. In the Texas jurisdiction and New Mexico jurisdiction, the Company's fixed fuel factor is subject to reduction if the utility materially overrecovers its allowable fuel costs under its existing fuel factor.

Rate tariffs currently applicable to FERC jurisdictional customers contain appropriate fuel and purchased power cost adjustment provisions designed to recover the Company's fuel and purchased power costs.

Federal Income Taxes and Investment Tax Credits

Deferred income taxes are provided as a result of timing differences in reporting income and expense items for financial statement and income tax purposes.

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

In December 1987, the Financial Accounting Standards Board issued SFAS No. 96 — Accounting for Income Taxes, which establishes new criteria to account for income taxes for fiscal years beginning in 1989, although earlier implementation is permitted. These criteria are based on the use of the liability method in determining deferred income taxes to be reflected on the Company's financial statements.

Adoption of SFAS No. 96 may require an adjustment in the year the statement is implemented or in an earlier year if the Company elects retroactive application. SFAS No. 96 requires the recognition of deferred tax liabilities on existing differences in reporting between the Company's financial statements and its reporting to tax authorities using current tax law. This recognition will require adjustments for the effect, among other items, of (1) the change in the corporate Federal income tax rate; (2) income tax benefits previously passed to the Company's ratepayers; and (3) differences in reporting temporary differences, such as allowance for equity funds used during construction and accumulated deferred investment tax credits.

The adjustments discussed above will require the Company to recognize additional deferred income taxes and a corresponding regulatory asset or liability to ratepayers with respect to the Company's regulated assets unless otherwise indicated by the Company's regulatory authorities. The overall financial statement impact will be determined by the regulatory treatment afforded the Company with respect to its regulated assets. The Company has not determined the financial statement impact with respect to its unregulated, non-utility operations because such impact is not reasonably estimable at this time.

Reclassification

Certain amounts in the consolidated financial statements for 1986 and 1985 have been reclassified to conform with the 1987 presentation.

B. Regulatory Matters

Texas

On March 22, 1988, the Texas Commission adopted, with certain modifications, a rate moderation plan that the Company and most of the parties to the Texas rate case had agreed to in an October 22, 1987 stipulation settlement of the case. The Commission is expected to issue its final order in the case, which will be based on the modified stipulation, by the end of March 1988. The Company's rate filing in April 1987, as amended, had requested a $77 million increase in annual Texas base rates, premised primarily upon (i) full inclusion in rate base of the Company's capital costs for Unit 1 at Palo Verde, Palo Verde deferred costs and two-thirds of the capital costs of Palo Verde Common Facilities and (ii) inclusion in cost of service of the Company's lease payments on Unit 2 to the extent of the book value of the plant sold and leased back.

The rate moderation plan adopted by the Texas Commission, which is intended to comply with SFAS No. 92, provides for a phased-in increase in the Company's annual Texas retail base rates of approximately $46 million (which is approximately 60% of the $77 million increase requested by the Company). The Company will receive cash rate increases of approximately $21 million in the first twelve months of the plan ($8.6 million net of fuel savings and miscellaneous revenues) and $7 million in each of the following three twelve-month periods. On a percentage basis, Texas base rates will increase by 13.7% in the first year of the plan (3.6% net of fuel savings and miscellaneous revenues), 4% in the second year of the plan and 3.5% in each of the third and fourth years of the plan. Base rates under the plan are expected to remain constant after the fourth rate increase through 1997. The deficiency in revenues resulting from these scheduled rate increases is deferred for collection in later years. All such deferrals are scheduled to be recovered within ten years. New Texas rates, based on the final order are expected to be implemented by late April 1988.

All construction prudence issues directly related to Palo Verde Units 1 and 2 and Common Plant, and any effect which Units 1 and 2 construction issues might have had on Unit 3, are settled by the Commission's adoption of the modified stipulation. Issues relating to the prudence of the Company's decisions with respect to its initial and continuing investment in Palo Verde, are also resolved insofar as they affect regulatory treatment of Units 1 and 2. In order to settle these issues, the Company had agreed, in the October 1987 stipulation, to an after-tax regulatory disallowance of approximately $24.4 million of the Company's investment in PVNGS (less than 2% of such investment). The Company recorded the disallowance, which did not require cash, in 1987.

All issues relating to excess capacity with respect to Units 1 and 2 are resolved under the plan for the life of the phase-in period. Certain issues relating to the prudence of construction costs specifically

incurred with respect to Unit 3, decisional prudence issues, as they affect regulatory treatment of Unit 3, relating to events occurring after the 1978 issuance of a certificate of convenience and necessity for Palo Verde by the Texas Commission and any possible issues of excess capacity relating to Unit 3 are, under the terms of the plan, reserved for future decision when the Company requests Unit 3 costs be included in Texas rates. Although Unit 3 achieved commercial operation in January 1988, it will not meet present Texas in-service rate criteria until completion of additional transmission facilities, presently scheduled for the end of 1989. Until Unit 3 meets such in-service criteria, it will be accounted for, insofar as the Texas jurisdictional portion is concerned, as plant under construction, and the Company will continue to capitalize all Texas jurisdictional costs of owning, operating and maintaining Unit 3 and will continue to accrue related AFUDC on Unit 3.

The Texas Commission deferred for future decision the recovery of regulatory expenses in the case and the issue of whether the Unit 2 sale and leaseback transactions were in the public interest. The Company's recovery of the expenses incurred by the Company and the City of El Paso in trying the case will be the subject of a separate hearing and order. All such expenses subsequently determined to be chargeable to ratepayers are provided to be recovered by the Company by means of a surcharge to Texas customers. As required by statute, the Company filed a report of the Unit 2 sale and leaseback transactions with the Texas Commission. When adopting the rate moderation plan, the Texas Commission included the effect of the Unit 2 transactions in rates because rates recognizing the transactions in the present case would not exceed those under traditional ratemaking methodology. However, the Commission specifically reserved a ruling on the question whether the transactions were in the public interest and should be reflected in rates in the future in lieu of such traditional methodology. The Company believes that the sale and leaseback transactions were an integral part of the rate moderation proposal and expects to be able to recover in rates the lease payments to the extent of the book value of the plant sold and leased back. See Note D of Notes to Consolidated Financial Statements.

The Company believes that the rate moderation plan adopted by the Texas Commission provides an adequate level of cash rate relief while enabling the Company to defer operating costs and its return on a substantial portion of its investment for subsequent recovery. Additionally, the Company believes that the settlement adopted by the Texas Commission and the phase-in plan contained therein provide an effective long-term resolution of the rate treatment of the Company's investment in PVNGS Units 1 and 2 and Common Plant. Management does not expect the ultimate resolution of the remaining issues of prudence relating to Unit 3 to result in a material disallowance of the costs incurred on Unit 3. The Company believes that if any excess generating capacity were to be found by the Texas Commission relating to Unit 3, the amount of any resulting exclusion from rate base would likely be temporary and would be restored to rate base in future rate proceedings to permit full recovery of substantially all of the Company's Texas jurisdictional investment in Unit 3.

New Mexico

In May 1987, the New Mexico Commission approved a March 1987 stipulation between the Company and jurisdictional parties which provides for a settlement regarding rate treatment of the Company's investment in the Palo Verde Station. The stipulation contains a phase-in plan, as defined in SFAS No. 92, for moderating the rates of the Company in the New Mexico jurisdiction and resolves any possible issues relating to the prudence of the planning, management and construction of Palo Verde, insofar as related to the Company, and settles any possible issue of excess generating capacity through 1993. Management, based upon present planning analyses, does not expect to have excess generating capacity. Additionally, the stipulation provides for continued full inclusion in rate base in New Mexico of the Company's investment in Palo Verde Unit 1, as well as recovery of Unit 2 lease payments (see Note D of Notes to Consolidated Financial Statements) to the extent of the book value of the plant sold and leased back, plus all related taxes.

The phase-in plan contained in the stipulation provides for annual rate increases, subject to annual verification of costs of service, for three years and deferral of any unrecovered costs during such period. Rates are required to be held constant after the third year of the plan until the earlier of full recovery of such deferrals or December 31, 1994. Any portion of such cost of service deferrals not recovered by December 31, 1994 will not be subject to recovery through New Mexico rates. SFAS No. 92, issued in August 1987 and effective for financial statements for fiscal years beginning after December 15, 1987, establishes specific criteria that must be met by a phase-in plan in order for costs that are deferred for future recovery by the regulator to be capitalized for financial reporting purposes. The Company's New Mexico phase-in plan does not currently meet such criteria. However, the Company has commenced negotiations with the parties to the New Mexico stipulation to amend the plan to meet the criteria of SFAS No. 92 and believes that such an amendment will be approved by the New Mexico Commission.

The first of the three scheduled rate increases, pursuant to the stipulation, was approved and became effective in November 1987 and provides for an annual increase in the Company's New Mexico base rates of $9.9 million, or a $5.0 million increase in total revenues, net of fuel savings. However, the phase-in plan limits the Company to an increase of $6.6 million in base revenues, or $1.8 million in total revenues, net of fuel savings. The difference between the approved base revenue increase of $9.9 million and the implemented increase of $6.6 million will be deferred. On November 20, 1987, the Company filed for the second increase in annual New Mexico retail rates. Under the terms of the phase-in plan, the increase will be limited to 3%, or $1.7 million with the balance to be deferred, and is expected to be effective in November 1988. The ability of the Company to defer, for financial reporting purposes, amounts equal to the difference between the approved and implemented rates (approximately $3.3 million in 1988) is dependent upon the approval of the parties to the stipulation and the New Mexico Commission of the Company's request to amend the stipulation to meet the requirements of SFAS No. 92.

The stipulation further provides that neither the capital costs of Palo Verde Unit 3, one-third of Common Plant and a proportionate share of certain Palo Verde transmission facilities (aggregating approximately $54.1 million) nor any Unit 3 operating expenses, including the lease payments attributable to the portion of Unit 3 sold and leased back, will at any time be included in the Company's rate base or receive any cost of service treatment insofar as the New Mexico jurisdiction is concerned. The costs related to the New Mexico portion of Unit 3 will need to be recovered through sales of power to wholesale customers. The Company believes, based upon current market conditions and forecasts of power demand, that it will recover such costs.

C. Palo Verde Nuclear Generating Station

The Company has expended $1.42 billion (including $413 million of AFUDC net of deferred taxes) through December 31, 1987 for its 15.8% interest in the three 1,270 MW nuclear generating units which comprise the Palo Verde Station, which is located near Phoenix, Arizona. At December 31, 1987, both Units 1 and 2 were complete and in commercial operation. Unit 3 was placed in commercial operation in January 1988.

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

	Electric Plant in Service	Accumulated Depreciation	Construction Work in Progress
December 31, 1987:			
Palo Verde Station	$588,168,000	$ (9,690,000)	$202,792,000
Other	121,589,000	(19,915,000)	10,990,000
December 31, 1986:			
Palo Verde Station	$626,492,000	$ (4,413,000)	$332,917,000
Other	110,232,000	(15,064,000)	13,848,000

The Company's investment, at cost, in the Palo Verde Station in the amount of $790,960,000 at December 31, 1987 excludes amounts which represent the book value of the Company's investment in Palo Verde Station which was sold and leased back during 1986 and 1987 and for which the related leases are accounted for as operating leases. See Note D of Notes to Consolidated Financial Statements for information regarding such transactions and the Company's lease obligations relating thereto. Additionally, the Company's investment, at cost, in the Palo Verde Station is net of a regulatory disallowance write-off in the amount of $38,323,000. See Note B of Notes to Consolidated Financial Statements.

Decommissioning and Spent Nuclear Fuel

The Company is required to plan and fund its share of the estimated costs to decommission Palo Verde, including the portion sold and leased back. The Company has assessed the requirements for the funding of such decommissioning and has determined, based upon an independent study, that the Company will have to fund approximately $97 million (stated in 1986 dollars) for decommissioning of Palo Verde. The Company will fund decommissioning over the estimated service life (approximately 40 years) for the portion of its owned interest in Palo Verde and over the term of the related leases (27 to 29 years) for the sold and leased back portions of Palo Verde. The Company is pursuing the establishment of tax qualified funds which, if approved, would provide for current deductibility over 40 years for Federal income tax purposes of amounts funded. The Company believes that all costs associated with nuclear plant decommissioning will be recoverable through rates.

The Company is currently funding its share of the obligation for spent nuclear fuel costs associated with Palo Verde through payments to the operating agent of Palo Verde of amounts prescribed by the Department of Energy.

Palo Verde Deferred Costs

Palo Verde deferred costs represent operating expenses incurred in connection with, and capitalization of AFUDC on, the Company's investment in Unit 1 and Unit 2 since their respective dates of commercial operation (Unit 1 — February 24, 1986; Unit 2 — September 22, 1986) to December 31, 1987. The Company's accounting treatment of such costs and AFUDC is pursuant to rate orders issued by its Texas and New Mexico regulators. A detail of Palo Verde deferred costs reflected in the accompanying consolidated balance sheets at December 31, 1987 and 1986 is as follows:

	1987	1986
Operating expenses deferred:		
Operations and maintenance and taxes	$ 37,465,000	$12,851,000
Lease payments — Unit 2	28,852,000	—
Other	(7,673,000)	(5,593,000)
Total operating expenses	58,644,000	7,258,000
AFUDC	44,018,000	23,995,000
Total	$102,662,000	$31,253,000

Pursuant to the stipulations approved by the New Mexico Commission (May 1987) and the Texas Commission (March 1988), the Palo Verde deferred costs, as well as a return thereon, will be amortized as cost of service and recovered through rates.

D. Sale and Leaseback Transactions

In August and December 1986 and December 1987, the Company consummated ten separate sale and leaseback transactions involving all of its 15.8% undivided interest in Palo Verde Unit 2, one-third of its undivided interest in certain Common Plant at Palo Verde and approximately 39.5% of its undivided interest in Unit 3. The Company remains responsible, under the terms of the leases, for all operating and maintenance costs, decommissioning costs, nuclear fuel costs, and other related operating costs of the leased-back facilities.

The aggregate consideration received by the Company in the sale and leaseback transactions was $934.4 million ($684.4 million in 1986 and $250.0 million in 1987). The proceeds from the transactions, which were based upon appraised fair market value, exceeded the cost of the assets sold by $194.0 million, which amount has been deferred and is being amortized into income over the primary terms of the leases. Nine of the ten transactions are accounted for as operating leases; the one transaction (sales price of $87.4 million), with an affiliate of a federal savings and loan association is accounted for as a financing transaction. An executive officer of a subsidiary of the Company serves on the board of directors of an affiliate of the savings and loan association and as an advisory director of the parent of the savings and loan association. During 1987, the Company acquired $60 million of newly issued, floating rate exchangeable preferred stock of the savings and loan association. Additionally, an affiliate of the savings and loan association received placement fees aggregating approximately $3.7 million in connection with the ten sale and leaseback transactions and the preferred stock transaction.

Leases related to Unit 2 and Common Plant expire in October 2013, while leases related to Unit 3 expire in January 2017. All of the leases contain certain renewal options and provide for repurchase options, at fair market value, at the termination of the lease. Additionally, all of the leases provide that upon the occurrence of specified events of loss or deemed loss events, as defined, the Company is obligated to pay the related equity investor an amount in cash which, primarily because of certain tax consequences, may exceed the equity investor's unrecovered equity investment. Upon payment of such amount and assumption of the debt portion of the purchase price of the undivided interest, the

undivided interest will be transferred to the Company. Approximately 20% of the aggregate purchase price of the undivided interests sold in the sale and leaseback transactions was provided by the equity investors, with the balance being provided through the issuance of non-recourse debt by the lessor/purchasers. Additionally, the Company has agreed to indemnify the lessors in certain circumstances against certain losses, including the loss of certain tax benefits, resulting from specified events.

One defined deemed loss event pursuant to the leases relates to legislative changes in the Price-Anderson Act (See Part I, Item 1 — "Facilities — Palo Verde — Liability and Insurance Matters"). Certain of the expected changes in the Price-Anderson Act could permit the equity investors in the Unit 2 sale and leaseback transactions to declare a deemed loss event under the related leases. However, such legislation includes a provision to the effect that a lessor in a bona fide lease of a nuclear generating facility will not be liable by reason of its interest as lessor for any legal liability arising from a nuclear incident, unless such lessor is in actual possession and control of such facility at the time of the incident. The Company believes that such provision will make declaration by any such equity investor of a deemed loss event less likely. Under the leases pertaining to Unit 3, certain amendments to or replacements of the Price-Anderson Act have been specifically deemed to be "safe harbor changes" which would not result in the occurrence of a deemed loss event. The bills passed by the House and the Senate should, in the Company's view, qualify as "safe harbor changes", although, because neither the content of any legislation that may finally become law nor the reaction which the equity investors may have to such legislation can be predicted with certainty, there can be no assurance that final legislation will constitute a "safe harbor". In addition, certain provisions in the Unit 2 sale and leaseback transaction leases purport to require the Company to carry and maintain, or to cause the Palo Verde operating agent to carry and maintain, specified insurance coverage and endorsements with respect to the leased Unit 2 interests. The Company has been informed that one or more of the endorsements that may be required by such leases are not currently available. As a result, the lessors may be entitled to declare a deemed loss event under their respective leases. The Company is unable to predict whether any of such equity investors would declare a deemed loss event even if it were entitled to do so.

The December 1986 and December 1987 transactions require the Company to provide letters of credit to the equity investors in support of payments of the equity portion of rent under the leases. At December 31, 1987, letters of credit aggregating approximately $158.7 million in maximum available credit were outstanding. One of the letters of credit requires that the Company maintain with the issuing bank cash collateral of $30 million as security for the letter of credit.

Contemporaneously with the consummation of the December 1987 sale and leaseback transactions, the Company and the equity investors in the 1986 sale and leaseback transactions agreed to modifications of the documents for those transactions. The modifications require that the Company provide the six equity investors in the August 1986 sale and leaseback transactions with bank letters of credit, having an aggregate maximum available credit amount of approximately $160 million, and a term expiring not earlier than December 31, 1991, in support of the equity portion of rent under the related lease. In addition, the Company agreed to certain financial covenants with each of the eight equity investors in the 1986 sale and leaseback transactions requiring the Company to be in compliance at June 30, 1991 with specified interest and rental payment coverage ratios and debt to capitalization tests. If the Company fails to meet such financial covenants at that time, the equity investor can, in lieu of exercising remedies under the related lease, including drawing on the letter of credit, elect to require that the letter of credit be renewed for successive one year periods until such financial covenants are met as of June 30 in a subsequent year.

As part of the modifications, the Company agreed to place in a bank escrow account, pending the satisfaction of the conditions described below, $243.1 million, to be used to retire all of the long-term debt of the Company maturing during the period from June 1988 through February 1991. The Company placed in escrow $138 million of the proceeds from the December 1987 sale and leaseback

transactions and funded the balance of the escrow by transferring certain investments to the escrow account. During March 1988, the Company prepaid, with funds withdrawn from the escrow account, $50 million principal amount of bank debt due in June 1988.

The escrowed funds are to be released upon (i) delivery of the letters of credit to the six equity investors in the August 1986 sale and leaseback transactions and (ii) execution and delivery of the amendments to the transaction documents for the 1986 sale and leaseback transactions required to implement the agreed upon modifications. If such letters of credit are not delivered by April 30, 1988, each subsequent rent payment under the six related leases is, under the terms of the modified agreements, to be increased by .35 percent of facility cost, such rent increase (approximately $3.5 million per annum) to continue until the earlier to occur of (x) the date of delivery of the required letter of credit and (y) the date as of which such letter of credit would have expired had it been in effect as required. The Company has commenced negotiations to secure the required letters of credit and expects that it will be able to provide such letters of credit and terminate the escrow.

The Company believes that it will be able to recover from ratepayers the lease payments to the extent of the book value of the plant sold and leased back, plus all related taxes ("book breakeven") and expects to recover the balance of the lease payments, approximately $17 million per year, from a return on the investment of the proceeds of the transaction and from sales of power from the portion of Unit 3 which has been deregulated in New Mexico. See Note B of Notes to Consolidated Financial Statements for a discussion of Texas and New Mexico regulatory matters. Lease expense under the leases accounted for as operating leases amounted to $40,919,000 during 1987, of which $26,164,000 was deferred. Future minimum annual rental payments required under such leases are as follows (in thousands):

Year ending December 31,	
1988	$ 75,297
1989	82,056
1990	82,056
1991	82,056
1992	82,056
Thereafter	1,770,543

E. Investments and Other Short-Term Investments

Investments and other short-term investments are stated at their lower of cost or market and include, net of current market valuation allowance of $6,885,000 in 1987, investments and other short-term investments of $340,475,000 and $254,124,000 at December 31, 1987 and 1986, respectively. Investments and other short-term investments consist primarily of investments in preferred and common stock, mortgage backed securities and repurchase agreements.

Gross unrealized gains were $1,239,000 and gross unrealized losses were $6,844,000 in 1987. Included in non-utility operating revenues were losses on write-downs of subsidiary investments of $5,726,000 and $5,347,000 in 1987 and 1986, respectively.

Net realized losses on investments included in the determination of net income were $12,039,000 in 1987. The cost of the securities sold was based on the actual cost of each such security at the time of sale.

F. Common Stock

Employee Stock Purchase Plan

The Company has an employee stock purchase plan under which eligible employees are granted options twice each year to purchase, through payroll deductions, shares of common stock from the

Company at a specified discount from the fair market value of the stock; provided, however, if the option price exceeds the fair market value of the stock on the date of exercise of the option, the Company, in lieu of selling the stock at the option price, purchases in the over-the-counter market, for the accounts of the participants, that number of shares of common stock as the aggregate of the payroll deductions under the plan will purchase.

Automatic Dividend Reinvestment and Stock Purchase Plan

In December 1987, the Company instituted the automatic dividend reinvestment and stock purchase plan under which holders of record of common stock purchase, on the open market through a purchasing agent, additional shares of common stock by automatic reinvestment of their cash dividends from the Company and/or making optional cash payments of up to $3,000 (but not less than $25) per calendar quarter. In December 1987, shareholders purchased through the purchasing agent 63,998 shares for $911,000, an average price of $14.23 per share.

Prior to January 1987, the Company had a dividend reinvestment and stock purchase plan under which holders of record of common stock purchased from the Company, at fair market value, shares of common stock by reinvesting cash dividends and/or making optional cash payments of up to $3,000 per calendar quarter.

Employee Stock Ownership Plan and Trust

The Company has a qualified employee stock ownership plan under which common stock with a fair market value (as defined) equal to the sum of a specified amount of the Company's investment tax credit (based on payroll costs) is contributed by the Company to the plan. No employee cash participation is permitted by the plan. Due to the provisions of the Tax Reform Act of 1986, as of December 31, 1987, the Company will no longer participate or make contributions to the plan.

Customer Stock Purchase Plan

The Company has a customer stock purchase plan under which shares of Company common stock may be purchased from the Company at fair market value by its Texas and New Mexico customers. Customers may purchase shares by making cash payments in amounts of not less than $25 per payment nor more than $3,000 total investment per calendar quarter. Dividends paid on all shares purchased by a participant are automatically reinvested in additional shares, except for those participants who request in writing the stock certificates and cash dividends.

Employee Stock Compensation Plan

The Company has an employee stock compensation plan under which shares of Company common stock are issued from time to time to eligible employees. Under the plan, the Board's Compensation Committee may direct the issuance from time to time of Company common stock to compensate employees for past services rendered to the Company or to pay for various employee benefits with common stock rather than with cash.

Leveraged Employee Stock Ownership Plan and Trust

The Company has a leveraged employee stock ownership plan and trust (LESOP) which has borrowed money that was used to purchase 1,297,051 shares of Company common stock on the open market for allocation to eligible employees. During 1987 and 1986, the LESOP allocated 194,557 and 162,131 shares, respectively.

Employee Stock Option Plan

In December 1987, the Board of Directors approved the adoption of the Company's Employee Stock Option Plan authorizing the issuance of up to 1,000,000 shares of common stock pursuant to options which may be granted at not less than fair market value. The plan is subject to shareholder and New Mexico Commission approval.

Common Stock Purchase

During 1987 the Company purchased 626,000 shares of its common stock for $9,996,000, resulting in a charge to common stock of $5,983,000, a charge to retained earnings of $2,852,000 and a charge to additional paid-in capital of $1,161,000, due to the excess of the purchase price over the average issue price.

Changes in Common Stock

Changes in common stock are as follows:

	Common Stock	
	Shares	Amount (In thousands)
Balance December 31, 1984	33,697,555	$310,663
Issuances of Common Stock:		
1985	1,046,362	15,370
1986	766,221	12,767
1987	88,042	1,482
Purchase of Common Stock:		
1987	(626,000)	(5,983)
Balance December 31, 1987	34,972,180	$334,299

Shares reserved for issuance under the stock plans described above, excluding the Employee Stock Option Plan, were 1,084,801 at December 31, 1987.

G. Preferred Stock

Preferred Stock, Redemption Required

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

	December 31,				Optional Redemption Price Per Share at December 31, 1987
	1987		1986		
	Shares	Amount (In thousands)	Shares	Amount (In thousands)	
$10.75 Dividend	68,000	$ 6,800	72,000	$ 7,200	$105.250
$ 8.44 Dividend	115,600	11,560	127,600	12,760	106.330
$ 8.95 Dividend	112,500	11,250	127,500	12,750	106.710
$ 9.50 Dividend	60,000	6,000	80,000	8,000	104.750
$10.125 Dividend	250,000	25,000	250,000	25,000	110.125
$11.375 Dividend	500,000	50,000	500,000	50,000	111.750
	1,106,100	$110,610	1,157,100	$115,710	

Each series of preferred stock, redemption required, is entitled to the benefits of its respective annual sinking fund which requires redemptions of a specified number of shares or a percentage of outstanding shares. The sinking fund redemption price on all series is $100 per share plus accrued dividends.

Each series, other than the $10.75 series, is redeemable at the option of the Company at various stated redemption prices. Optional redemptions are also generally restricted as to the timing of redemption when such redemptions are a part of or in anticipation of any refunding involving the issue of indebtedness or preferred stock having an effective interest cost or effective dividend cost of less than the stated dividend rate of each preferred stock series.

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

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

1988	$ 3,750
1989	8,750
1990	18,750
1991	16,750
1992	16,750

Redemptions and repurchase of preferred stock, redemption required were as follows:

	Shares	Amount (In thousands)
Balance at December 31, 1984	1,374,000	$137,400
Redemption of Preferred Stock, $10.75 Dividend	(4,000)	(400)
Repurchase of Preferred Stock, $8.80 Dividend	(50,000)	(5,000)
Redemption of Preferred Stock, $8.44 Dividend	(6,000)	(600)
Redemption of Preferred Stock, $8.95 Dividend	(7,500)	(750)
Balance at December 31, 1985	1,306,500	130,650
Redemption of Preferred Stock, $10.75 Dividend	(4,000)	(400)
Redemption of Preferred Stock, $8.44 Dividend	(10,400)	(1,040)
Redemption of Preferred Stock, $8.95 Dividend	(15,000)	(1,500)
Redemption of Preferred Stock, $9.00 Dividend	(100,000)	(10,000)
Redemption of Preferred Stock, $9.50 Dividend	(20,000)	(2,000)
Balance at December 31, 1986	1,157,100	115,710
Redemption of Preferred Stock, $10.75 Dividend	(4,000)	(400)
Redemption of Preferred Stock, $8.44 Dividend	(12,000)	(1,200)
Redemption of Preferred Stock, $8.95 Dividend	(15,000)	(1,500)
Redemption of Preferred Stock, $9.50 Dividend	(20,000)	(2,000)
Balance at December 31, 1987	1,106,100	$110,610

Preferred Stock, Redemption not Required

Following is a summary of preferred stock at December 31, 1987 which is not redeemable except at the option of the Company:

	Shares	Amount	Optional Redemption Price Per Share
		(In thousands)	
$4.50 Dividend	15,000	$ 1,534	$109.00
$4.12 Dividend	15,000	1,506	103.98
$4.72 Dividend	20,000	2,001	104.00
$4.56 Dividend	40,000	4,000	100.00
$8.24 Dividend	52,450	5,157	103.40
	142,450	$14,198	

During 1987, the Company purchased 47,550 shares of the $8.24 preferred stock for $3,989,000, resulting in a charge to preferred stock of $4,675,000 and an increase in additional paid-in capital of $686,000 due to the excess of the issue price over the purchase price.

All preferred stock issues (redemption required and redemption not required) are entitled, in preference to common stock, to $100 per share plus accrued dividends, upon involuntary liquidation. All issues are entitled to an amount per share equal to the applicable optional redemption price plus accrued dividends, upon voluntary liquidation.

H. Long-Term and Financing and Capital Lease Obligations

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

	Redemption Price at December 31, 1987(1)	December 31, 1987	December 31, 1986
		(In thousands)	
Long-Term Obligations:			
First Mortgage Bonds(2):			
4¼% Series, issued 1958, due 1988	100.00%	$ 6,100	$ 6,100
4⅝% Series, issued 1962, due 1992	100.81	10,385	10,385
6¾% Series, issued 1968, due 1998	102.33	24,800	24,800
7¾% Series, issued 1971, due 2001	104.00	15,838	15,838
9% Series, issued 1974, due 2004	104.69	20,000	20,000
10½% Series, issued 1975, due 2005	106.69	15,000	15,000
8½% Series, issued 1977, due 2007	105.74	25,000	25,000
9.95% Series, issued 1979, due 2004	109.95	21,811	22,874
16.35% Series, issued 1981, due 1991(14)	—	—	40,000
16.20% Series, issued 1982, due 2012(14)	—	—	60,000
14½% Series, issued 1984, due 1989	—	25,000	25,000
14% Series, issued 1984, due 1989	—	50,000	50,000
13¼% Series, issued 1984, due 1994	—	29,500	29,500
12¾% Series, issued 1984, due 1989	—	22,000	22,000
Balance forward		$265,434	$366,497

	December 31, 1987	December 31, 1986
	(In thousands)	
Balance forward	$ 265,434	$ 366,497
Pollution Control Bonds(3):		
Secured by Second Mortgage Bonds(2):		
Variable rate bonds, due 2014, net of $11,442,000 and $10,683,000, respectively, on deposit with trustee(4)	52,058	52,817
Variable rate refunding bonds, due 2014, net of $4,998,000 and $4,796,000, respectively, on deposit with trustee(5)	32,102	32,304
Variable rate refunding bonds, due 2015(6)	59,235	59,235
Unsecured:		
Variable rate refunding bonds, due 2013, net of $5,848,000 and $5,518,000, respectively, on deposit with trustee(4)	29,957	30,287
Floating rate notes secured by Second Mortgage Bonds(2)(7):		
Due 1988 ($25,000,000 paid in January 1988, $50,000,000 paid in March 1988)	75,000	75,000
Due 1991	70,000	70,000
Promissory notes:		
Secured:		
Due 1996 ($543,000 due in 1988)(8)	58,683	59,163
Due 1987 through 2007 ($1,901,000 due in 1988)(9)	31,688	13,121
Unsecured(10):		
Due 1989 to 1992 ($812,000 due in 1988)	47,103	47,830
Mortgage notes payable, interest 9.5% and 12% per annum. Payable in installments through 2007 ($94,000 due in 1988)	5,479	8,074
Total long-term obligations	726,739	814,328
Financing and Capital Lease Obligations:		
Financing obligation, Palo Verde Unit 2 ($452,000 due in 1988)(11)	82,813	87,427
Turbine lease ($719,000 due in 1988)(12)	11,624	12,631
Nuclear fuel ($29,098,000 due in 1988)(13)	73,772	50,070
Total financing and capital lease obligations	168,209	150,128
Total long-term and financing and capital lease obligations	894,948	964,456
Amounts due within one year:		
Current maturities and planned redemptions(14)	(115,782)	(130,963)
Unamortized discount and premium	(1,448)	(1,572)
	$ 777,718	$ 831,921

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

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

The First Mortgage Indenture securing its First Mortgage Bonds provides for sinking and improvement funds. Except as otherwise noted, the Company is required to make annual payments to the trustee equivalent to 1%, $1,180,000 at December 31, 1987, of the greatest aggregate principal amount of such series outstanding prior to a specified date. The Company has generally satisfied the 1% requirements for such series by relinquishing the right to use a net amount of additional property for the issuance of bonds or by purchasing bonds in the open market and expects to continue these practices. With respect to the 9.95% and 13¼% series, commencing in April 1985 and April 1990, respectively, the Company is required to make annual cash payments to the trustee equivalent to 4¼% and 20%, respectively, of the greatest aggregate principal amount of such series outstanding at any one time prior to a specified date, $1,063,000 in 1987 and 1986; the cash payments must be applied to redeem bonds of the 9.95% and 13¼% series at 100% of the principal amount thereof. With respect to the 12¾%, 14½% and 14% series bonds, no sinking fund is required.

In accordance with certain provisions of the First Mortgage Indenture, payments of cash dividends on common stock are restricted to an amount equal to retained earnings accumulated after December 31, 1966, plus $4,100,000. Retained earnings in the amount of approximately $175,800,000 are unrestricted as to the payment of cash dividends at December 31, 1987.

The Second Mortgage Bonds have been issued to secure the three variable rate pollution control bond issues due 2014 and 2015, as well as the two floating rate note issues due 1988 and 1991.

(3) The funds on deposit with a trustee at December 31, 1987 represent a portion of the proceeds from pollution control revenue bonds and accumulated related interest income, which are to be disbursed as needed to pay the cost of acquiring, constructing, reconstructing, improving, maintaining or furnishing the pollution control facilities financed.

(4) The variable rate bonds due 2013 and 2014 are supported by long-term irrevocable letters of credit issued by a bank. These bonds bear interest at such rate, determined annually, as will cause the bonds to have a market value which approximates, as nearly as possible, their par value. During 1987 the interest rate on the variable rate bonds, due 2014, was 4.625%. With respect to the variable rate refunding bonds, due 2013, the interest rate during 1987 was 4.25% until November 1, 1987 and 6.75% thereafter. The bonds may be required to be repurchased at the holder's option and are subject to mandatory redemption upon the occurrence of certain events and are redeemable at the option of the Company under certain circumstances.

(5) These bonds are supported by a long-term irrevocable letter of credit issued by a bank and bear interest at such rate, determined annually, as will cause the bonds to have a market value which approximates, as nearly as possible, their par value. During 1987 the bonds bore an interest rate of 4.5% until June 18, 1987 and 4.375% thereafter. The bonds may be required to be repurchased at the holder's option and are subject to mandatory redemption upon the occurrence of certain events and are redeemable at the option of the Company under certain circumstances.

(6) These bonds are supported by a long-term irrevocable letter of credit issued by a bank and bear interest at a weekly, daily or term interest rate (5.5% until July 31, 1987 and 5% thereafter). The bonds may be required to be repurchased at the holder's option, are subject to mandatory redemption upon the occurrence of certain events, and are redeemable at the option of the Company under certain circumstances.

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

(8) Consists of advances to a subsidiary on two promissory notes which provide for aggregate borrowings in the amount of $60,000,000 with interest at 12.75% per annum for the renovation of a building and construction of additional facilities. Principal and interest is payable in quarterly installments of $2,000,000. At January 1, 1996, the estimated unpaid principal balance in the amount of $54,000,000 is due and payable in full. The loan is secured by the properties and other assets to which it relates, a subsidiary's pledge of approximately $30,000,000 of its preferred stock portfolio and temporary cash investments and certain other collateral of a subsidiary.

(9) Consists of notes with interest rates ranging from 5% to 14.125%, principally secured by properties and other assets of subsidiaries and $2,193,000 of letters of credit issued by banks.

(10) Two unsecured notes due in 1989 have interest rates of 14.125% and 14% per annum. Due in 1990 are two notes, one of which has an interest rate of 13% per annum and the other is fixed (approximately 10.365%) pursuant to the terms of an interest-rate exchange agreement with the lending bank. One unsecured note due 1992 is floating rate, 8.625% at December 31, 1987.

(11) In December 1986, the Company entered into a financing obligation related to one sale and leaseback transaction involving Palo Verde Unit 2 (See Note D of Notes to Consolidated Financial Statements). Semiannual payments, including interest (using an assumed interest rate of 9.01%), which began in July 1987, are $4,181,000, with the last payment being $2,091,000 in July 2013.

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

(13) In January 1985, December 1985, and June 1987, the Company entered into lease arrangements with an independent trust with respect to nuclear fuel loaded into Units 1, 2 and 3 at Palo Verde Station. The Company is accounting for the leases as capital leases and, accordingly, has recorded obligations which have balances of $11,070,000 for Unit 1, $17,025,000 for Unit 2 and $45,677,000 for Unit 3 at December 31, 1987 (interest rate of 9.6% at December 31, 1987). Quarterly lease payments based on units of heat production with respect to Unit 1 began in the first quarter of 1986 and in the first quarter of 1987 for Unit 2 and will begin in the second quarter of 1988 for Unit 3.

(14) In December 1987, the Company deposited $60,000,000 with the Trustee under the Company's First Mortgage Bond Indenture, which deposit was used to redeem on February 1, 1988 $60,000,000 principal amount of the Company's First Mortgage Bonds, 16.20% Series due 2012. Accordingly, such First Mortgage Bonds are not reflected in the December 31, 1987 balance sheet. The 16.35% series bonds, in the amount of $40,000,000, were redeemed during 1987.

Scheduled maturities of long-term and financing and capital lease obligations and sinking fund requirements at December 31, 1987 are as follows (in thousands):

1988	$117,959
1989	138,303
1990	43,084
1991	85,898
1992	49,678

Reference is made to Part I, Item 1 — "Utility Construction Program and Financing Capability — Restrictions on Financing Capabilities".

I. Short-Term Obligations

At December 31, 1987, the short-term obligations of the Company and its subsidiaries totaled approximately $174,176,000. Such obligations consisted of commercial paper and notes payable. The Company and its subsidiaries maintained informal lines of credit which totaled approximately $152,449,000 and $34,785,000, respectively, at December 31, 1987. Most of these arrangements provide for the payment of lines of credit fees of various negotiated amounts. At December 31, 1987, the Company and its subsidiaries had approximately $40,000,000 and $28,854,000, respectively, of advances outstanding under their respective lines of credit. The subsidiaries borrow independently from third parties, without recourse to the Company (except for certain borrowings pursuant to the Company's nuclear fuel and fuel oil financing arrangements) for the purposes of their various investments and activities. See Part I, Item 1 — "Utility Construction Program and Financing Capability — Restrictions on Financing Capabilities".

J. Federal Income Taxes

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

	Years Ended December 31,		
	1987	1986	1985
		(In thousands)	
Tax effect of:			
Operating income:			
Depreciation differences	$ 8,110	$ 15,187	$ 7,365
Deferred fuel revenues	3,901	(4,995)	2,779
Provisions for rate refunds	(777)	(6,125)	—
Allowance for borrowed funds used during construction	5,743	12,805	19,178
Allowance for borrowed funds on deferred costs	3,240	4,794	—
Taxes capitalized	3,953	2,916	3,166
Nuclear fuel expense differences	(6,477)	(3,301)	2,940
Deferred and capitalized Palo Verde operation and maintenance expenses	25,377	5,967	4,370
Sale and leaseback transactions:			
Palo Verde Unit 2 gain	—	(129,062)	—
Palo Verde Unit 3 gain	(55,022)	—	—
Amortization of gain and other	127	—	—
Tax leases	(1,740)	4,140	4,733
Other	(2,746)	2,844	(277)
Other income:			
Regulatory disallowance of plant costs	(13,937)	—	—
Other	(207)	734	1,831
Total deferred taxes	$(30,455)	$ (94,096)	$46,085

Federal income tax provisions are less than the amounts computed by applying the statutory rate of 40% in 1987 and 46% in 1986 and 1985 to book income before Federal income taxes. Details are as follows:

	Years Ended December 31,		
	1987	1986	1985
		(In thousands)	
Tax computed at statutory rate	$ 17,399	$ 58,524	$ 71,216
(Decreases) increases due to:			
Allowance for equity funds used during construction	(12,776)	(22,814)	(26,381)
Dividends received not subject to Federal income tax	(5,009)	(1,465)	(2,124)
Other	(1,124)	(2,635)	(965)
Total Federal income tax expense	$ (1,510)	$ 31,610	$ 41,746
Effective Federal income tax rate	(3.47)%	24.85%	26.96%

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

	Years Ended December 31,		
	1987	1986	1985
		(In thousands)	
Current income taxes:			
Operating	$ 21,715	$ 38,092	$ (5,825)
Other income	(5,074)	5,094	5,250
Total	16,641	43,186	(575)
Deferred income taxes:			
Operating	(16,311)	(94,830)	44,254
Other income:			
Regulatory disallowance of plant costs	(13,937)	—	—
Other	(207)	734	1,831
Total	(30,455)	(94,096)	46,085
Charge (benefit) equivalent to investment tax credit:			
Operating	6,592	83,450	(217)
Other income	4,784	(138)	(3,044)
Total	11,376	83,312	(3,261)
Amortization of investment tax credit:			
Operating	(1,899)	(792)	(503)
Tax effect of change in accounting method	2,827	—	—
Total Federal income tax expense	$ (1,510)	$ 31,610	$ 41,746

At December 31, 1987, the Company's accumulated deferred income taxes reflected in the accompanying consolidated balance sheet includes accumulated deferred income tax credits of $236,059,000 and accumulated deferred income tax debits of $195,879,000.

At December 31, 1987, an indirect subsidiary of the Company, 80% of which was acquired in 1986, has a tax net operating loss carryforward of $26,800,000 and a financial net operating loss carryforward of $26,600,000. Such indirect subsidiary also has investment tax credit carryforwards of approximately

$860,000. The tax net operating loss carryforwards expire as follows: $18,000,000 in the year 2000 and $8,800,000 in the year 2001 and the investment tax credit carryforwards expire between 1990 and 2000. The tax net operating losses and investment tax credit carryforwards can only be utilized to offset future taxable income of such indirect subsidiary. At December 31, 1987, the Company and its subsidiaries did not have any other investment or rehabilitation tax credit carryforwards for Federal income tax purposes.

At December 31, 1987, the cumulative net amount of income tax timing differences on which deferred income taxes have not been provided approximated $14,000,000.

K. Commitments and Contingencies

As of December 31, 1987, the Company has provided reserves in the amounts of $13,025,000 and $958,000 in connection with amounts collected for Texas retail sales and for wholesale power sales, respectively, which are subject to refund.

The estimated aggregate costs of completion and betterments related to Units 1, 2 and 3 at the Palo Verde Nuclear Generating Station to be incurred by the Company subsequent to December 31, 1987, are approximately $47,000,000, which includes AFUDC (net of related deferred tax) in the amount of $1,800,000.

Other construction commitments for the Company subsequent to December 31, 1987, total approximately $35,800,000, which includes AFUDC (net of related deferred tax) in the amount of $5,200,000.

The Company has a nuclear fuel purchase commitment with an independent trust which is not reflected in the Company's balance sheets. The amount of such commitment at December 31, 1987 was $32,700,000. The Company has elected and intends to continue to elect to purchase the heat produced from the fuel in the trust as the basis for payment for fuel loadings. The trust had a line of credit of $125,000,000, of which $121,800,000 was drawn at December 31, 1987. The trust's financing is based upon a letter of credit with a three-year term which is annually extended by one year if notice to the contrary is not given to the trust by the issuing bank. The letter of credit is currently scheduled to expire on January 8, 1991.

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

Reference is made to Part I, Item 1 — "Facilities — Palo Verde — Liability and Insurance Matters" for a discussion of the expected changes in the Price-Anderson Act and their effect on the Company's potential assessment in the event of a nuclear incident.

L. Pension Plan

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

Contributions from the Company and certain subsidiaries are based on the amounts required to be funded under provisions of the plan as actuarially calculated.

The assets of the plan consist primarily of insurance contracts, certificates of deposit, corporate equity securities, corporate obligations, and U.S. government and agency obligations.

In 1987, the Company adopted SFAS No. 87 — Employers Accounting for Pensions. Net periodic pension cost under SFAS No. 87 is made up of the components listed below as determined using the projected unit credit actuarial cost method. For prior years, the Company's net periodic pension cost was determined using the aggregate actuarial cost method.

Net periodic pension cost for 1987 (in thousands):

Service cost for benefits earned during the period	$ 1,296
Interest cost on projected benefit obligation	2,815
Actual return on plan assets	(208)
Net amortization and deferral	(1,691)
Net periodic pension cost	$ 2,212

The funded status of the plan and amount recognized in the Company's balance sheet at December 31, 1987 are presented below (in thousands):

Actuarial present value of benefit obligations:	
Vested benefit obligation	$(27,456)
Accumulated benefit obligation	$(28,687)
Projected benefit obligation	$(34,689)
Plan assets at fair value	28,630
Projected benefit obligation in excess of plan assets	(6,059)
Unrecognized net loss from past experience	42
Unrecognized transition obligation	5,832
Accrued pension liability	$ (185)

The assumed discount rate and the rate of increase in compensation levels used in determining the actuarial present value of projected benefit obligation were 8.75%,and 7%, respectively. The expected long-term rate of return on plan assets was 8%.

The pension costs in 1987, 1986 and 1985 were $2,212,000, $2,605,000 and $1,448,000, respectively, which includes amortization of unrecognized transition obligations over a fifteen-year period beginning in 1987.

M. Selected Quarterly Financial Data (Unaudited)

	1987 Quarters(1)				1986 Quarters(1)			
	1st	2nd	3rd	4th	1st	2nd	3rd	4th
	(In thousands of dollars except for per share data)							
Operating revenues:								
Utility	$78,400	$81,756	$95,454	$ 82,182	$77,557	$78,967	$86,276	$75,309
Non-utility	11,852	14,754	34,858	50,860	1,290	923	(3,964)(4)	5,208
Operating expenses	67,959	71,611	98,241	112,785	58,615	59,211	55,997	58,184
Operating income	22,293	24,899	32,071	20,257	20,232	20,679	26,315	22,333
Net income (loss)	24,610	20,762	5,041(2)	(5,405)(3)	26,372	22,302	27,751	19,189(5)
Net income (loss) applicable to common stock	21,321	17,472	1,814	(8,491)	22,744	18,674	24,122	15,889
Net income (loss) per share of common stock	.60	.49	.05	(.23)	.65	.54	.68	.45

(1) The selected quarterly financial data for operating revenues, operating expenses and operating income (loss) differs from that presented in the Company's quarterly reports on Form 10-Q due to the decision of the Company, beginning in the fourth quarter of 1987 to segregate such items as to utility and non-utility. Prior to the fourth quarter of 1987 such amounts were not material and were condensed into other income (deductions). Net income (loss) for each of the quarters has not been affected by such change.

(2) The decline in net income during the third quarter of 1987 as compared to the second quarter of 1987 was due primarily to the Company's provision for estimated regulatory disallowance of plant costs. See Note B of Notes to Consolidated Financial Statements.

(3) The decline in net income during the fourth quarter of 1987 as compared to the third quarter of 1987 was due primarily to the realized and unrealized security losses.

(4) Non-utility operating revenues decreased in the third quarter of 1986 compared to the second quarter primarily due to the provision for unrealized investment losses.

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

N. Segment Information and Significant Customer

Beginning in 1987, the Company's operations are classified into two different business segments — utility and non-utility. Non-utility operations result principally from the Company's implementation of its diversification program, which was approved in general by the New Mexico Commission in August 1987. The New Mexico Commission permitted the Company, through a newly-formed subsidiary, PasoTex Corporation, to invest up to $120 million (plus any earnings thereon). As of December 31, 1987, the Company has transferred approximately $110 million to PasoTex. PasoTex has invested approximately $65 million of its funds in certain non-publicly held preferred stocks and has invested the balance of its funds principally for the acquisition of controlling or complete ownership interests in certain entities, including a speciality steel products manufacturer, a lamp manufacturer, a furniture manufacturer and an oil country tubular goods marketer. Assets, liabilities and results of operations from the dates of acquisition of acquired companies to December 31, 1987 have been included in the accompanying consolidated financial statements. The pro forma effects on operations for the current year, as if the acquisitions had been made at the beginning of the year, are not material. The purchase price of and subsequent advances to the acquired companies aggregated $45.6 million as of December 31, 1987. The aggregate purchase price has been assigned to the net assets acquired based upon the fair value of such assets and liabilities at the dates of acquisition.

The financial information pertaining to the Company's utility and non-utility business segments for the year ended December 31, 1987 is as follows (in thousands):

	Utility	Non-utility	Total
Operating revenues	$ 337,792	$112,324	$ 450,116
Operating income (loss) before income taxes	112,891	(3,274)	109,617
Depreciation and amortization	21,162	3,791	24,953
Interest expense	90,616	11,552	102,168
Cumulative effect of change in accounting method	4,240	—	4,240
Capital expenditures	121,771	8,829	130,600
Identifiable assets:			
Net utility plant	$1,215,293	$ —	$1,215,293
Net non-utility property, plant and equipment	82	104,271	104,353
Other	749,188	206,739	955,927
	$1,964,563	$311,010	$2,275,573

Prior to 1987, the Company had no material segments other than utility operations.

In 1987, Imperial Irrigation District, a wholesale customer, accounted for approximately $34,252,000, or 10.1%, of utility operating revenue.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

PART III

Item 10. Directors and Executive Officers of the Registrant

Information regarding directors is incorporated herein by reference from the 1988 Proxy Statement. Information regarding executive officers of the Company, under the caption "Executive Officers of the Registrant" in Part I, Item 1 above, is incorporated herein by reference.

Item 11. Executive Compensation

Incorporated herein by reference from the 1988 Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management

Incorporated herein by reference from the 1988 Proxy Statement.

Item 13. Certain Relationships and Related Transactions

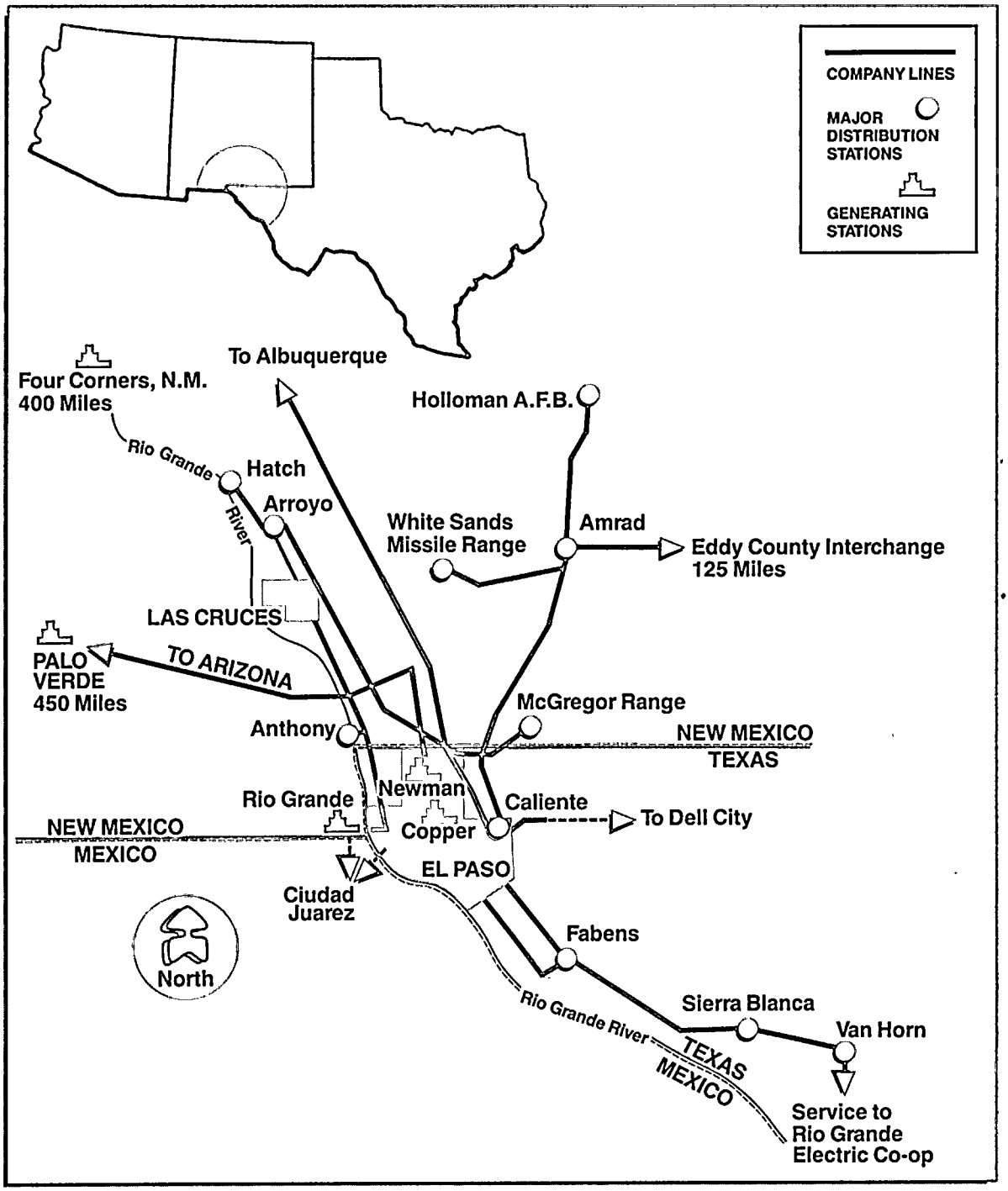
Incorporated herein by reference from the 1988 Proxy Statement.

PART IV

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

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

SERVICE AREA



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