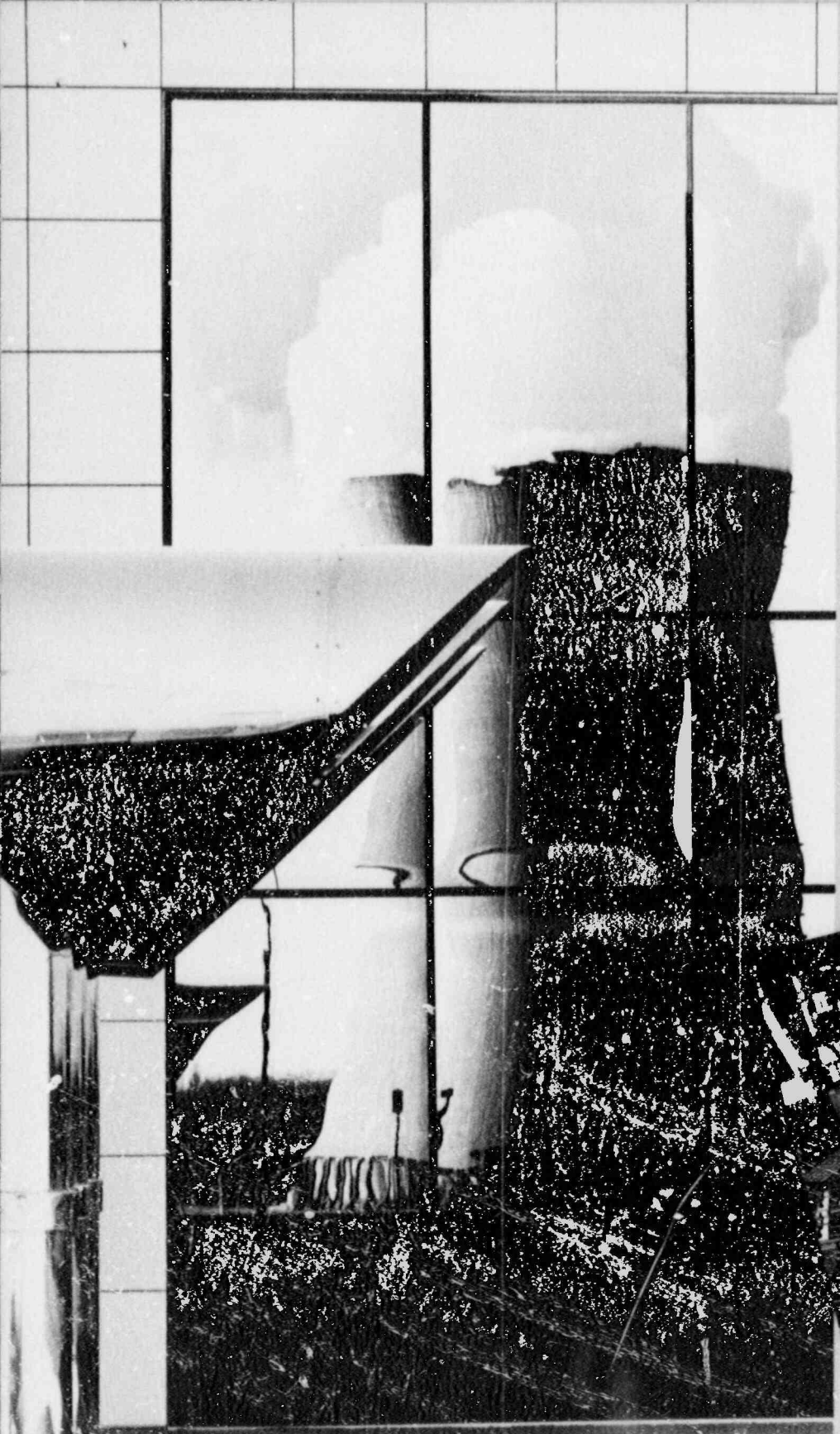
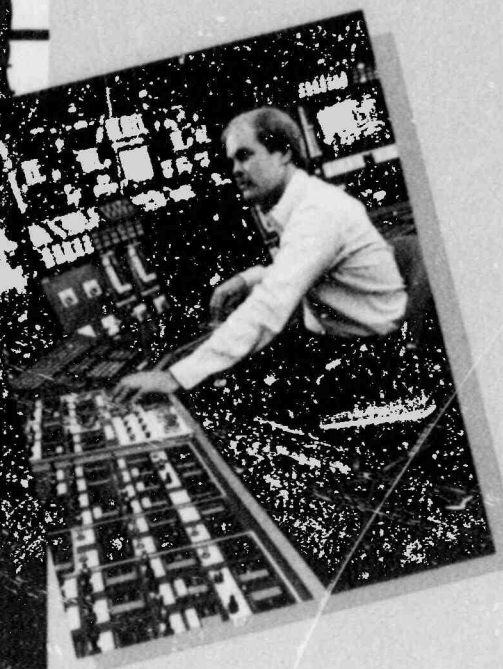
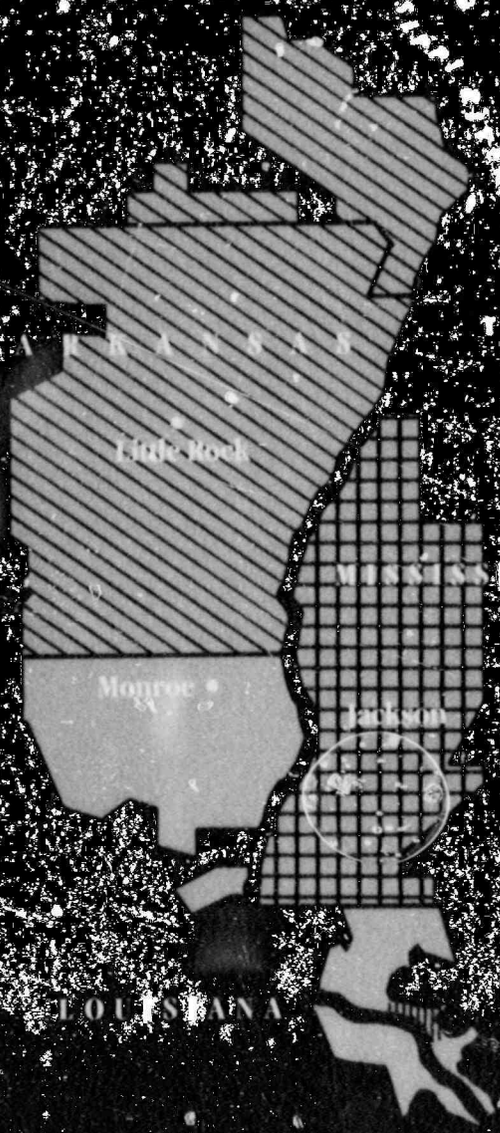
SYSTEM ENERGY
RESOURCES, INC.





1987
ANNUAL REPORT



SERVICE AREA

Arkansas Power & Light Company

Louisiana Power & Light Company

Mississippi Power & Light Company

New Orleans Public Service

THE COMPANY AND THE MSU SYSTEM

System Energy Resources, Inc. (SERI) is a nuclear generating company providing electricity to its sister companies and other electric utilities, and is responsible for the management and operation of Grand Gulf Nuclear Station, located 50 miles southwest of Jackson, Mississippi, near Port Gibson.

SERI is a member of one of the largest investor-owned public utility holding companies in the United States: Middle South Utilities, Inc. (MSU). Ranked fourth in assets among the nation's electric and gas utilities in 1987, the MSU System is the leading electric energy supplier to the Middle South, a region comprised of Arkansas, Louisiana, Mississippi, and southeastern Missouri. Gas service is provided in New Orleans and portions of Arkansas and Missouri.

The MSU System utilizes a vast, interconnected transmission and distribution network and a balanced system of fossil fuel and nuclear generating plants to meet the electric needs of 1.68 million customers in the 91,000-square-mile Middle South area, encompassing 1,300 communities with an aggregate population of five million.

At the heart of the System are five operating companies working together: Arkansas Power & Light Company, Louisiana Power & Light Company, Mississippi Power & Light Company, New Orleans Public Service Inc., and SERI.

Additional subsidiaries include: MSU System Services, Inc., which provides various technical, administrative, and corporate services that benefit all of the MSU System companies in common; System Fuels, Inc., a fuels subsidiary; and Electec, Inc., a subsidiary that markets the commercial capabilities, expertise, and resources of the System companies.

The combined companies of the MSU System are committed to providing the Middle South region economical, dependable service that can be tailored to meet specific energy requirements, and to strengthening the regional economy through economic and educational development initiatives.

On the cover: Windows of Grand Gulf's Energy Services Center reflect the cooling tower of the 1250 megawatt nuclear generating plant as emergency generator air intakes stand guard.

Inset: Operations Shift Supervisor Karl Ehrhardt at the Grand Gulf Unit 1 control panel.

PRESIDENT'S MESSAGE

System Energy Resources, Inc. (SERI) was founded in 1986 as the newest operating company of Middle South Utilities, Inc. Since that time, the Company has made significant advancements in its nuclear operations, reflecting the dedicated spirit and exacting professionalism of the total organization.

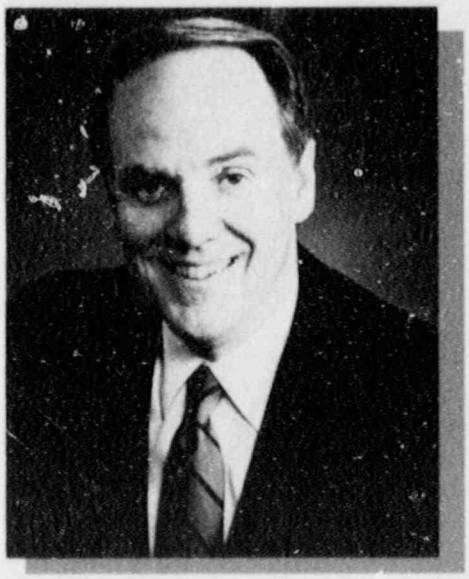
As we reported in 1986, our commitment at SERI—both individually and corporately—is keyed on being "the absolute best in an industry that daily demands the highest levels of excellence." Following 1987, our first full calendar year at SERI, that commitment continues to be our hallmark.

With our new corporate motto, "Excellence in Energy," serving as our standard, we are building on our record of accomplishment and will be constantly striving to make our present and future plans results-oriented realities in 1988 and beyond.

Achievements

A number of 1987 operating milestones serve as evidence of the wisdom and progress of our management approach:

- Grand Gulf Unit 1 set a **world record** for boiling water reactors (BWR's) when, in February, it produced 30,930,000 kilowatt-hours of electricity during a 24-hour period.
- Grand Gulf Unit 1 established a **world record** for continuous operation during the second cycle for reactors of its type.
- The superior quality of our nuclear training programs was recognized in April by the National Academy for Nuclear Training when all of SERI's programs were accredited, and SERI was accepted as a full member of the Academy.
- After an extensive assessment, the Institute of Nuclear Power Operations rated the Grand Gulf Nuclear Station in its second highest category, stating that: "Overall performance is exemplary. Industry standards of excellence are met in many areas. No significant weaknesses noted."
- Grand Gulf's equivalent availability for 1987 was in excess of 77 percent. This high level of generating performance far exceeded the industry average, especially when considering that the reactor was refueled during this period. One of the most important indicators of a plant's performance, equivalent availability is the amount of time (expressed in percent) that the plant was capable of producing maximum power.
- Actual 1987 cost of service was 16 percent *below* budgeted levels due to close control of financial outlays and increased efficiency.
- Support for Grand Gulf Unit 2 was limited to the minimum required to maintain the unit as a viable option to meet the future energy needs of the Middle South System. Construction on Unit 2 was suspended in 1985.
- Unit 1 completed its second refueling outage on schedule and within budget.
- SERI employees celebrated a special landmark accomplishment last July: 3,000,000 hours worked without a lost-time accident. In addition, the total collective radiation dose at Grand Gulf met the corporate performance target, which is significantly under the industry average for BWR's. Both of these achievements demon-



strate that SERI's commitment to safety was in no way compromised by its continuing attention to cost reduction.

- Significant strides were made by the SERI Human Resources Department in pursuing studies and systems to address important personnel issues, such as pay based on performance, planning for management succession, and identifying and developing talented employees with growth potential.

Unquestionably, these noteworthy advancements were the products of the energetic spirit of cooperation, mutual respect and teamwork that's alive at SERI. While we are justifiably proud of these first-year results, we believe that "Excellence in Energy" is just beginning to reflect our commitment to leadership in the nuclear industry.

Financial

We entered 1987 expecting to make major progress on a plan to substitute long-term financing for SERI's substantial bank debt. However, for most of the year, we were precluded from effecting long-term financing with SERI's financial condition remaining relatively unchanged. This situation was anchored to the February 25 decision by the Mississippi Supreme Court on Mississippi Power & Light Company's (MP&L) retail rates and the resulting regulatory and legal uncertainty. (These factors are discussed in-depth later in this report.)

However, SERI's prospects for improved financial condition were favorably affected in the fourth quarter—primarily by the October 5 decision by the United States Supreme Court to hear MP&L's appeal. By year-end, this factor contributed to our successful completion of two first mortgage bond issues for a total of $300 million.

Uncertainties continue to exert unsettling and adverse effects on the Company's financial condition. SERI's future financial performance will be influenced significantly by the resolution of certain pending financial, rate and regulatory issues (all of which are fully discussed elsewhere in this report.)

New director

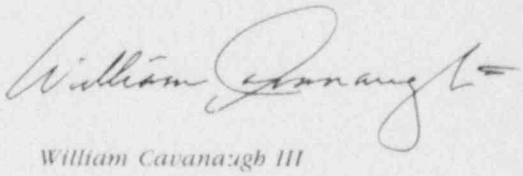
An important addition was made to the SERI Board of Directors in 1987 with the election of Dr. Joseph M. Hendrie. A former chairman of the Nuclear Regulatory Commission and past president of the American Nuclear Society, Dr. Hendrie is internationally recognized as a leader in the field of nuclear energy. He is currently senior scientist of the Brookhaven National Laboratory and we are honored to have him as a part of the SERI team.

The road ahead

We at SERI believe that our record for 1987 indicates that we are on the right track and moving in a positive direction. While much remains to be achieved, our view of the future continues to be influenced by unprecedented opportunity.

Our challenge for the coming year is to take the accomplishments of 1987 and build on them with the realistic expectation that we have the talent and tenacity to reach even higher levels of operating superiority.

We are grateful for the confidence and support you have shared with us and are committed to establishing a benchmark of excellence that will be the pride and envy of the nuclear industry.



William Cavanaugh III
President & Chief Executive Officer

REPORT OF MANAGEMENT

The management of System Energy Resources, Inc. has prepared and is responsible for the financial statements and related financial information included in this annual report. The financial statements are prepared in accordance with generally accepted accounting principles, consistently applied. Financial information included elsewhere in this report is consistent with the financial statements.

To meet its responsibilities with respect to financial information, management maintains and enforces a system of internal accounting controls which is designed to provide reasonable assurance, on a cost effective basis, as to the integrity, objectivity and reliability of the financial records and as to the protection of assets. This system includes communication through written policies and procedures and testing by a comprehensive internal audit program.

The independent certified public accountants provide an objective assessment of the degree to which management meets its responsibility for fairness of financial reporting. They regularly evaluate the system of internal accounting controls and perform such tests and other procedures as they deem necessary to reach and express an opinion on the fairness of the financial statements.

Management believes that these policies and procedures provide reasonable assurance that its operations are carried out with a high standard of business conduct.

MANAGEMENT'S FINANCIAL DISCUSSION AND ANALYSIS

Financial Condition

The financial condition of System Energy Resources, Inc. (Company) remained relatively unchanged during most of 1987. However, improvement was evident in the fourth quarter primarily because of positive developments in respect of several uncertainties which have adversely affected the Company's financial condition. Specifically, the Company's prospects for improved financial condition were favorably affected in the fourth quarter by (1) the October 5, 1987, United States Supreme Court decision to hear full argument of Mississippi Power & Light Company's (MP&L) appeal of the Mississippi Supreme Court's February 25, 1987, decision (February 25 Decision), which reversed and remanded MP&L's Grand Gulf 1 rate order, (2) the Federal Energy Regulatory Commission's (FERC) order on November 30, 1987, which reaffirmed and reinstated the FERC decision on June 13, 1985 (June 13 Decision), regarding the allocation of Grand Gulf 1 capacity and energy among Arkansas Power & Light Company, Louisiana Power & Light Company, MP&L and New Orleans Public Service Inc. (NOPSI), collectively referred to as the "System operating companies," and (3) the United States Supreme Court's denial on December 14, 1987, of petitions for certiorari filed by various parties in connection with the June 13 Decision, thereby upholding the FERC's jurisdiction to allocate Grand Gulf 1 costs. Due principally to the favorable impact of the United States Supreme Court's October 5, 1987, decision, the Company successfully completed two issuances of first mortgage bonds in the fourth quarter totaling $300 million.

However, the Company's financial condition was and will continue to be adversely affected by the uncertainties related to (1) disputes involving rate structures implemented by the System operating companies which have changed, are in litigation (in particular, the outcome of MP&L's pending appeal to the United States Supreme Court of the February 25

Decision) or have been or currently are subject to prudence reviews or disallowances (in particular, the recent action of the Council of the City of New Orleans, Louisiana (Council) imposing an additional prudence disallowance of $135 million on NOPSI, which has had a material adverse effect on NOPSI's financial condition and, if not reversed, could render NOPSI insolvent in a short period of time), (2) the status of Grand Gulf 2, construction of which has been suspended, (3) a FERC audit of the Company and the Grand Gulf Nuclear Generating Station (Grand Gulf Station), and (4) the continuing controversies over the Grand Gulf Station and the allocation of capacity and energy from Grand Gulf 1 to the System operating companies.

Under traditional utility regulatory principles and the doctrine of federal preemption, costs incurred under wholesale rates approved by the FERC should be allowed to be recovered from retail ratepayers. As a result of the FERC's June 13 Decision, all of the costs, capacity and energy associated with the Company's 90 percent share of Grand Gulf 1 were allocated to the System operating companies upon commercial operation of the unit. All of the System operating companies have received rate relief for their allocated share of costs associated with Grand Gulf 1 which they believe will be sufficient to allow them to meet their respective Grand Gulf 1 obligations. The System operating companies' future financial condition [illegible] dependent on the continued effectiveness of their respective rate orders. However, final and favorable resolution of disputes over adequate retail rate relief for certain of the System operating companies has yet to be achieved, and some of the rate structures as initially implemented have changed, are in litigation, or have been or currently are the subject of prudence reviews or disallowances. Further changes to or reversals of existing rate structures could occur, depending upon further actions of regulatory bodies or the courts.

In this connection, a prudence investigation conducted by the Council relative to NOPSI's Grand Gulf 1 cost recovery resulted in a February 4, 1988, decision by the Council to require NOPSI to write off and not to recover from its retail electric customers $135 million of its deferred Grand Gulf 1 costs, in addition to the $51.2 million of such costs that NOPSI had previously agreed to absorb in its March 1986 rate settlement. NOPSI is seeking relief in the courts from this finding by the Council of alleged imprudence, but, as a result of its inability to obtain injunctive relief that would stay the effectiveness of the Council's actions, NOPSI was required to record the write-off in 1987. If the Council's actions are not reversed, NOPSI may not be able to obtain the requisite funds to meet its ongoing obligations, including its obligations to the Company, and could be rendered insolvent in a short period of time, possibly as early as the second quarter of 1988. See Note 7, "Commitments and Contingencies."

In addition, on February 25, 1987, the Mississippi Supreme Court reversed and remanded the September 1985 order of the Mississippi Public Service Commission (MPSC) granting permanent rate relief to MP&L with respect to its recovery of Grand Gulf 1 costs. Subsequently, MP&L filed an appeal of the February 25 Decision with the United States Supreme Court and also filed an application asking that Court to stay the mandate of the February 25 Decision pending final disposition of the appeal. On June 1, 1987, such stay was granted, conditioned upon the posting of a good and sufficient bond, in a manner and amount to be determined by the Mississippi Supreme Court. On June 10, 1987, the Mississippi Supreme Court entered an Order Setting Bond with respect to the possible refunding to customers of amounts collected by MP&L pursuant to its Grand Gulf 1 rate order (approximately $279.8 million as of December 31, 1987). The requirements of the Mississippi Supreme Court's Order Setting Bond have been and are currently being satisfied. These bonding arrangements provide that, among other things, the Company shall make monthly payments into a trust account for the benefit of MP&L's ratepayers equal to MP&L's Grand Gulf 1 rate collections from June 1, 1987, until final resolution of MP&L's appeal to the United States Supreme Court. Through March 15, 1988, the Company had paid into the trust account approximately $138.5 million under this requirement, and such payments are estimated to average approximately $14 million per month through June 1988, at which time it is expected that a decision shall have been rendered by the United States Supreme Court in MP&L's appeal. Further, the Company and Middle

(Management's financial discussion and analysis, continued)

South Utilities, Inc. (MSU) have provided corporate guarantees (in the amount of approximately $206 million as of June 30, 1987) of MP&L's refund obligations for Grand Gulf 1 collections from September 1985 through June 1987 if refunds are required. To the extent that either the Company or MSU makes payments to discharge MP&L's obligation to make refunds to its customers as a result of an adverse final judicial determination of MP&L's appeal of the February 25 Decision, the Company and/or MSU, as the case may be, will have an immediate right of reimbursement from MP&L. The Company has agreed, at the request of its creditor banks, to demand immediate reimbursement from MP&L on account of all amounts paid by the Company (whether directly or from monies placed in trust) on behalf of MP&L and to take promptly all reasonable actions necessary to collect such amounts from MP&L.

On October 5, 1987, the United States Supreme Court decided to hear full argument of MP&L's appeal of the Mississippi Supreme Court's February 25 Decision but postponed further consideration of the United States Supreme Court's jurisdiction to the hearing of the case on the merits. The stay granted by the United States Supreme Court on June 1, 1987, remains in effect. Accordingly, MP&L is continuing to collect its Grand Gulf 1 rates, subject to refund, pending the Court's decision. Oral argument before the United States Supreme Court was held on February 22, 1988. It is expected that the case will be decided by the end of June 1988. See Note 7, "Commitments and Contingencies."

On June 24, 1987, the United States Court of Appeals for the District of Columbia Circuit (D.C. Circuit) reversed, in part, and remanded the June 13 Decision (June 24 Remand) to the FERC for reconsideration of its decision to equalize the capacity costs of all nuclear plants among the System operating companies. The D.C. Circuit also asked the FERC for an explanation of the criteria used to determine what constituted "undue discrimination" under the Federal Power Act and why the June 13 Decision was not unduly discriminatory.

Further, various parties filed petitions for certiorari with the United States Supreme Court seeking review of that portion of the D.C. Circuit's decision that affirmed the FERC's jurisdiction to allocate Grand Gulf 1 costs. Certain of these parties requested that the United States Supreme Court consider their challenges to FERC jurisdiction at the same time the Court considered MP&L's rate case appeal. On December 14, 1987, the United States Supreme Court denied, without comment, these petitions for certiorari, thereby leaving in place that part of the D.C. Circuit's decision upholding the FERC's jurisdiction to allocate Grand Gulf 1 costs.

On November 30, 1987, the FERC issued an order in response to the June 24 Remand whereby the FERC reaffirmed and reinstated the June 13 Decision, thus maintaining the previous allocation of Grand Gulf 1 capacity and energy among the System operating companies. In issuing its November 30 order, the FERC found that the allocation of Grand Gulf 1 costs in the June 13 Decision was not unduly discriminatory. Requests for rehearing of the FERC's November 30 order were filed by various parties (other than the System operating companies), and by order dated January 29, 1988, the FERC denied these requests. Petitions for review of the FERC's November 30, 1987, and January 29, 1988, orders have been filed with the D.C. Circuit by various parties.

It is not possible at this time to predict the ultimate outcome of these matters, including possible reallocation, if any, or the effect thereof upon the Company and the System operating companies, including possible refunds, if any. Any material modification of the allocation established by the June 13 Decision, as reaffirmed by the FERC's November 30, 1987, order, could give rise to additional litigation, disputes and challenges in the affected jurisdictions.

In addition, the System operating companies have initiated a study, currently scheduled to be completed in the near future, to determine whether a more equitable method of allocating future costs, including those relating to Grand Gulf 1, would be appropriate.

Also, prudence issues involving MP&L's Grand Gulf 1 costs remain unresolved. See Note 8, "Rate and Regulatory Matters—Rate Activity—System Operating Companies," for more information regarding a prudence investigation involving MP&L. The outcome of this matter and whether MP&L's current rate structure will remain in effect cannot be

predicted at this time.

In addition to the impact of the resolution of the issues stated above, the Company's net income, earnings coverages and cash flow could be significantly and adversely affected if certain findings stemming from a FERC audit of the Company and the Grand Gulf Station are ultimately sustained. See Note 7, "Commitments and Contingencies—FERC Audit."

Reference is hereby made to Note 7, "Commitments and Contingencies—Suspended Construction Project—Grand Gulf 2," for information concerning Grand Gulf 2, including issues regarding the recovery by the Company of its investment in Grand Gulf 2 and information with respect to adoption by the FERC of its "50/50 sharing" policy regarding recovery of cancelled or abandoned plant costs. Also, see Note 7, "Commitments and Contingencies—Statements of Financial Accounting Standards Nos. 71 and 90," for information regarding the effect on the Company of certain new accounting standards should Grand Gulf 2 be abandoned.

Reference is made to Note 2, "Income Taxes," for information concerning the issuance of Statement of Financial Accounting Standards No. 96, Accounting for Income Taxes, and the potential effect on the Company upon implementation.

Liquidity and Capital Resources

The Company's capital requirements noted below are based on certain assumptions and judgments with respect to, among other things, the outcome of pending regulatory and judicial proceedings. If future events vary significantly from these assumptions, additional capital requirements could result. See Note 7, "Commitments and Contingencies—Capital Requirements and Financing."

During the period 1985-1987, the Company incurred construction expenditures totaling $411.0 million, including allowance for funds used during construction (AFDC) of $120.4 million. Funding for this construction activity was obtained primarily from the sales of first mortgage bonds and pollution control revenue bonds, bank borrowings, payments received from certain of the System operating companies for advance power purchases and income tax benefits. The Company's total construction expenditures (excluding nuclear fuel expenditures, net of amounts assumed to be financed under lease, estimated at $0.4 million during the period 1988-1990) for 1988, 1989, and 1990 are expected to be approximately $44.7 million, $43.3 million and $44.1 million, respectively, for its 90 percent ownership in the Grand Gulf Station. These estimated expenditures assume no activities at Grand Gulf 2 except for demobilization and suspension.

The Company estimates that it will require approximately $613.9 million from internal and external sources for the period 1988 through 1990 to refinance maturing indebtedness (excluding $158 million of unsecured short-term notes which matured and were paid in January 1988), to meet sinking fund obligations and to finance its other capital requirements (primarily the construction expenditures listed above). Furthermore, the Company may enter into arrangements for the sale and leaseback of property in which the proceeds from such transactions could be used to retire debt at par. In addition, the Company's nuclear fuel leases are likely to terminate during this period if the credit lines supporting the nuclear fuel leases terminate, as scheduled. It is currently assumed that either the credit lines will be extended or that alternative credit lines will be arranged. To the extent, however, that this does not occur, additional financing requirements of up to $215 million could result. Further, in connection with MP&L's bonding order from the Mississippi Supreme Court, the Company is required to deposit each month into a trust account for the benefit of MP&L's ratepayers an amount equal to MP&L's cash collections from its customers for its Grand Gulf 1 obligations from June 1, 1987, until MP&L's current appeal to the United States Supreme Court is resolved.

During 1987, the Company was delayed in effecting permanent financing due to uncertainties surrounding the System operating companies' retail rate relief with respect to Grand Gulf 1 and uncertainties associated with the decision of the D.C. Circuit reversing, in part, and remanding the June 13 Decision. However, the Company's ability to finance was enhanced by the United States Supreme Court's decision in October 1987 to hear full argument of MP&L's appeal of the February 25 Decision. Subsequently, the Company issued and sold $200 million of First Mortgage Bonds, 14% Series due 1994, through a public offering on November 24, 1987, and on December 1, 1987, the Company closed a private placement of $100 million of First Mortgage Bonds, 14.34% Series

(Management's financial discussion and analysis, continued)

due 1992. The proceeds from these sales, coupled with internally generated funds, were used to repay those payments deferred under the U.S. and Foreign Bank Loan Agreements (discussed below), as well as the $158 million of unsecured short-term notes which matured in January 1988, and for other corporate purposes.

In addition, on February 29, 1988, an agreement was entered into by the Company for the sale and leaseback of up to $50 million of the unleased nuclear fuel on its balance sheet. The lease extends for one year with monthly extensions thereafter until notice is given by either party thereto. Also, on February 29, 1988, the Company entered into an arrangement for the sale of certain of its customer accounts receivable during the period February 29, 1988, through May 16, 1988. The terms of this arrangement provide for the periodic sale by the Company of up to approximately $52.6 million through March 15, 1988, and up to approximately $38.4 million thereafter of certain of its customer accounts receivable, including all collections relating thereto, without recourse to the Company. This arrangement is terminable by either party upon thirty days written notice.

Subsequent to the above financing arrangements, the Company anticipates that its projected cash flow for the period 1988-1990 will enable it to satisfy its cash requirements from internal sources and that no additional funds will be required from external sources for this period. However, many uncertainties continue to confront the Company and the Middle South System, and, depending upon the ultimate resolution of such uncertainties and the effects thereof upon the Company and the Middle South System, the Company may be required to obtain funds from external sources. If the Company is unable to obtain sufficient funds from external sources on a timely basis, the Company could develop such liquidity constraints that its ability to meet its obligations to its creditors might be impaired, which could lead to acceleration of the maturity of the Company's indebtedness (but only upon further action by the requisite percentage of the Company's creditors) unless waivers were obtained, the debt were restructured or other arrangements could be negotiated.

In view of the above-mentioned uncertainties, the delay in effecting permanent financing and the need to conserve available cash resources, the Company obtained the consents of the applicable creditor banks to defer the September 1, 1987, payment of $125 million due the U.S. Banks and to further defer the August 31, 1987, payment (originally due August 5, 1987) of $47.25 million due the Foreign Banks, in each case to not later than December 15, 1987. The deferred installments were paid on November 25, 1987, upon receipt of the proceeds from the sale of first mortgage bonds. In connection with these deferrals, the Company agreed, among other things, not to pay dividends on its common stock to MSU until all loans outstanding under these Agreements are fully paid, the scheduled final maturities being in February 1989. The Company is presently current with respect to scheduled semi-annual payments under these Agreements. See Note 3, "Lines of Credit and Related Borrowings."

The Company has amended the U.S. and Foreign Bank Loan Agreements to convert borrowings thereunder to term loans. At December 31, 1987, the Company had outstanding $247.5 million and $126.75 million under the U.S. and Foreign Bank Loan Agreements, respectively, and had an obligation to collateralize with cash the remaining $126.0 million of the letter of credit under the Series C Pollution Control Revenue Bonds. In addition, in February 1988, the Company paid the scheduled $47.25 million semi-annual installment due under the Foreign Bank Loan Agreement. On March 1, 1988, the Company paid the scheduled semi-annual installment of $125 million due under the U.S. Bank Loan Agreement, $42.2 million of which was paid into the escrow account for the Series C Letter of Credit Banks.

The Company is currently authorized by the Securities and Exchange Commission (SEC) to effect short-term borrowings in an aggregate amount outstanding at any one time of up to 10% of its capitalization. The Company is limited by certain of its credit agreements to short-term borrowings in an aggregate amount not exceeding the lesser of 5% of capitalization (approximately $234.5 million at December 31, 1987) or $200 million. At December 31, 1987, the Company did not have any available bank lines of credit. However,

the Company received SEC authorization, effective January 1, 1987, to effect short-term borrowings through the System Money Pool (Money Pool), which allows certain System companies to borrow from, or lend to, certain other System companies. The Company's participation in the Money Pool is subject to the availability of funds, which at any particular time may be limited. At December 31, 1987, the Company had no outstanding borrowings from the Money Pool. On April 30, 1987, the Company issued and sold, to a group of domestic and foreign institutional investors, $158 million of unsecured promissory notes, which matured and were paid in January 1988.

At December 31, 1987, the earnings coverage for the Company's first mortgage bonds, which must be a minimum of 1.5 times the annual mortgage interest requirements for issuance of additional first mortgage bonds, was 3.01. Assuming an annual interest rate of 13% and subject to the availability of bondable property, the Company could have issued $1,685 million of additional first mortgage bonds (plus any bonds issued for refunding purposes). However, at December 31, 1987, unfunded bondable Grand Gulf 1 property would only support the issuance of approximately $179 million of additional first mortgage bonds.

In the event of any issuance of preferred stock, it is expected that the Company's Articles of Incorporation will be amended to require a minimum earnings coverage of 1.5 times the sum of the pro forma annual interest charges and annual preferred stock dividends (subject to reduction to 1.25 with SEC approval). At December 31, 1987, such earnings coverage for preferred stock would have been 1.57, which would have allowed the Company to sell $118 million of preferred stock, assuming an annual dividend rate of 13%.

In connection with the financing of the Grand Gulf Station by the Company, MSU has undertaken in the Capital Funds Agreement to provide, or cause to be provided to the Company, sufficient capital, (1) to maintain the Company's equity capital at an amount at least equal to 35 percent of total capitalization, (2) to construct, own and place in commercial operation the Grand Gulf Station, (3) to provide for preoperating expenses and interest charges of the Company, (4) to permit the continuation of commercial operation after commencement thereof, and (5) to pay in full all indebtedness for borrowed money of the Company, whether at maturity, on prepayment, on acceleration or otherwise.

Results of Operations

The Company began to report results of operations subsequent to the July 1, 1985, commercial operation date of Grand Gulf 1. Prior to that time, the Company's income statement reflected only nonoperating items.

Prior to the commercial operation of Grand Gulf 1, all of the Company's net income had been the equity component of AFDC, which consisted solely of non-cash credits to the income statement that represented a reasonable return on equity funds used for construction. With the commercial operation of Grand Gulf 1, the Company's net income began reflecting cash earnings resulting from the allocation to the System operating companies of the unit's capacity and energy. Net income, exclusive of the equity component of AFDC, aggregated $198.6 million, $188.2 million, and $97.6 million, respectively, for the years 1987, 1986, and 1985.

For the years 1987 and 1986, total AFDC was insignificant. Total AFDC for 1986 decreased $229.0 million from the year ended December 31, 1985. Total AFDC for 1985 was $224.4 million ($207.6 million of which accrued during the first half of 1985). The higher AFDC amounts through June 30, 1985, reflected the increasing amount of construction work in progress attributable to the Grand Gulf Station, the increasing amount of long-term debt outstanding, and higher prevailing interest rates. Subsequent to June 30, 1985, the decreasing amounts of AFDC reflect the cessation of the accrual of AFDC on Grand Gulf 1 concurrent with its July 1, 1985, commercial operation and, to a lesser extent, the cessation of the accrual of AFDC on Grand Gulf 2 following the suspension of construction of that unit in September 1985. Total AFDC for the years 1987 and 1986 also reflected the impact of normalizing the income tax effect of utilizing state income tax loss carryforwards.

For the twelve months ended December 31, 1987, operating revenues and operating expenses remained relatively unchanged, with an increase of only $2.8 million, or 0.3 percent, and $24.3 million, or

(Management's financial discussion and analysis, continued)

4.9 percent, respectively, over the same 1986 period. However, operating revenues and operating expenses increased $435.7 million, or 83.1 percent, and $220.7 million, or 81.4 percent, respectively, in 1986 over 1985 due to 1986 reflecting a full year of Grand Gulf 1 operation.

Net income for the year 1987 increased $9.7 million, or 5.1 percent, over the year 1986 due to a combination of several factors. The decrease in overall interest expense, as discussed below, resulted in a decrease in interest expense related to Grand Gulf 2, which is not recovered through rates. In addition, an increase in interest income on temporary investments, which also is not reflected in rates, contributed to an increase in net income. These changes, partially offset by an increase in taxes on other income, were the primary factors which resulted in a net income increase in 1987 as compared to 1986. Net income decreased $28.9 million, or 13.3 percent, for the twelve months ended December 31, 1986, over the same 1985 period, primarily as a result of the cessation of the accrual of AFDC, as discussed above.

Depreciation expense increased $37.3 million, or 64.2 percent, in 1987 as compared to 1986. Effective January 1, 1987, the depreciation method was changed from the units-of-production method to a straight-line basis. The use of the straight-line method in 1987 resulted in increased depreciation expense over the prior year, due primarily to the fact that the units-of-production method was applied in a year of significantly low generation. For the year 1986, depreciation expense increased $20.3 million, or 53.6 percent, as compared to 1985, reflecting a full year of commercial operation of Grand Gulf 1.

Fuel expense increased $21.6 million, or 47.7 percent, in 1987 as compared to 1986. During 1987, the plant consistently operated at a higher capacity level than in 1986, resulting in an increase in the amount of fuel burned and a corresponding increase in fuel expense. An entire year of Grand Gulf 1 operation in 1986 is reflected by the increase in fuel expense of $15.7 million, or 53.5 percent, in 1986 as compared to 1985.

Income taxes on the Company's income statement prior to commercial operation of Grand Gulf 1 reflected the tax benefit that has been or will be realized during the carryforward periods resulting from the Company's federal tax losses included in the MSU consolidated income tax return. In the years 1987, 1986, and 1985, respectively, the Company charged approximately $201 million, $234 million, and $119 million of income tax expense to operations due to the recognition of taxable earnings related to the commercial operation of Grand Gulf 1. Income tax expense charged to operations in 1987 declined $32.7 million, or 14.0 percent, from 1986 due primarily to the enactment of the Tax Reform Act of 1986, which effectively reduced the maximum corporate income tax rate from 46% to 34% effective July 1, 1987. Income tax expense charged to operations in 1986 increased $115.1 million, or 96.8 percent, over the same 1985 period, as a result of a full year of Grand Gulf 1 commercial operation in 1986.

Total interest expense declined $26.4 million, or 8.3 percent, in 1987 as compared to 1986. Interest expense for the year 1986 declined $57.2 million, or 15.2 percent, from the year 1985. The lower interest expense was due primarily to a decrease in amounts outstanding under the Company's U.S. and Foreign Bank Loan Agreements and lower interest rates on such borrowings in 1987, as compared to 1986, and in 1986, as compared to 1985. Also, the 1986 decrease from 1985 reflected a lower balance in 1986 of power purchase advance payments on which interest accrued. These declines were partially offset by increases in interest expense associated with the issuance of additional first mortgage bonds and pollution control revenue bonds in late 1985 and 1986, and the issuance of first mortgage bonds and short-term notes in 1987.

Interest on long-term debt decreased $40.5 million, or 12.9 percent, for the year 1987, as compared to 1986, and decreased $36.6 million, or 10.4 percent, for the year 1986, as compared to 1985. These decreases were due to a smaller amount of long-term debt outstanding for most of the year and lower prevailing interest rates on both floating rate bank debt and refinanced debt.

Other interest expense increased $14.1 million, or 276.6 percent, in 1987, as compared to 1986, and decreased $20.6 million, or 80.1 percent, in 1986, as compared to 1985. The increase in 1987 was due primarily to the issuance in April

1987 of $158 million of short-term notes, which matured and were paid in January 1988. The decrease in 1986, as compared to 1985, was primarily due to the decrease in interest on power purchase advance payments made by certain of the System operating companies to the Company between January 1984 and June 1985. All of the advance payments had been utilized as credits against the operating companies' purchased power billings by March 31, 1986. The 1986 decrease in interest reflected the decrease in the balance of the advance payments.

Summary

The financial condition of the Company remained relatively unchanged during most of 1987. Some improvement was evident in the fourth quarter, however, because of favorable developments in the resolution of several uncertainties. On October 5, 1987, the United States Supreme Court agreed to hear full argument of MP&L's appeal of the February 25 Decision. Further, the FERC issued an order on November 30, 1987, which reaffirmed and reinstated the June 13 Decision, and on December 14, 1987, the United States Supreme Court, by denying petitions for certiorari filed by various parties, upheld the FERC's jurisdiction to allocate Grand Gulf 1 costs. Due principally to the favorable impact of the United States Supreme Court's October 5, 1987, decision, the Company successfully completed two issuances of first mortgage bonds in the fourth quarter totaling $300 million.

However, the Company continues to be confronted with several uncertainties which, if adversely resolved, could affect its ability to meet its financial commitments and provide a reasonable return to MSU. Certain of the System operating companies' respective Grand Gulf 1 rate structures have changed, are in litigation, or have been or currently are subject to prudence reviews or disallowances. Further, as a condition of MP&L obtaining a stay from the United States Supreme Court in connection with MP&L's appeal of the February 25 Decision, the Company has (1) unconditionally co-guaranteed a corporate undertaking by MP&L to "self-insure" amounts collected through June 30, 1987, under MP&L's Grand Gulf 1 rate plan and (2) has been depositing each month into a trust account for the benefit of MP&L's ratepayers an amount equal to MP&L's cash collections from its customers for its Grand Gulf 1 obligations from June 1, 1987, until final resolution of MP&L's appeal to the United States Supreme Court. In addition, the Company's financial condition could be materially and adversely affected in the event all, or a substantial amount, of its investment in Grand Gulf 2 is ultimately not recovered. Also, the Company's net income, earnings coverages and cash flow could be materially and adversely affected if certain findings stemming from a FERC audit of the Company and the Grand Gulf Station are ultimately sustained. Finally, the continuing controversies surrounding the allocation of capacity and energy from Grand Gulf 1 could give rise to additional litigation. See Notes 7 and 8 for a further discussion of these matters and other contingencies.

BALANCE SHEETS

System Energy Resources, Inc., December 31	1987	1986
	(In Thousands)	
Assets		
Utility Plant (Notes 1, 5 and 7):		
Electric	$ 3,359,430	$ 3,328,964
Construction work in progress	24,662	28,664
Nuclear fuel (Note 9)	218,374	—
Total	3,602,466	3,357,628
Less—Accumulated depreciation	170,880	95,988
Utility plant — net	3,431,586	3,261,640
Other Investments:		
Letter of credit escrow (Note 5)	108,562	19,162
Decommissioning trust fund (Note 1)	2,774	—
Total	111,336	19,162
Current Assets:		
Cash	254	176
Temporary investments — at cost, which approximates market	234,279	42,584
Total cash and cash equivalents	234,533	42,760
Bonding trust arrangement (Note 7)	101,262	—
Accounts receivable:		
Associated companies	90,745	72,492
Other	2,849	6,275
Materials and supplies — at average cost	37,796	19,947
Prepayments	2,742	2,386
Unamortized fuel expense	1,575	2,860
Other	6,844	1,944
Total	478,286	148,664
Deferred Debits:		
Suspended construction project (Note 7)	889,780	908,572
Future benefits related to AFDC (Notes 1 and 2)	492,755	589,883
Unamortized premium on reacquired debt	13,424	16,250
Other	5,162	5,947
Total	1,401,121	1,520,652
Total	$ 5,422,329	$ 4,950,118

See Notes to Financial Statements.

	1987	1986
	(In Thousands)	
Capitalization and Liabilities		
Capitalization:		
Common stock, no par value, authorized 1,000,000 shares; issued and outstanding 789,350 shares (Note 4)	$ 789,350	$ 789,350
Retained earnings (Note 6)	1,359,905	1,161,104
Total common shareholder's equity	2,149,255	1,950,454
Long-term debt (Notes 3, 5 and 7)	2,245,155	2,266,824
Total	4,394,410	4,217,278
Current Liabilities:		
Currently maturing long-term debt (Notes 3, 5 and 7)	260,177	277,025
Notes payable (Note 3)	158,000	—
Obligations under capital lease (Note 9)	165,550	—
Accounts payable:		
Associated companies	1,919	2,676
Other	32,423	45,771
Taxes accrued	25,685	78,667
Interest accrued	54,327	56,073
Other	3,682	14,137
Total	701,763	474,349
Deferred Credits:		
Accumulated deferred income taxes (Notes 1 and 2)	311,378	246,386
Accumulated deferred investment tax credits (Notes 1 and 2)	11,828	12,105
Other	2,950	—
Total	326,156	258,491
Commitments and Contingencies (Notes 7 and 8)		
Total	$ 5,422,329	$ 4,950,118

STATEMENTS OF INCOME AND RETAINED EARNINGS

System Energy Resources, Inc. For the Years Ended December 31	1987	1986	1985
		(In Thousands)	
Operating Revenues	$ 962,549	$ 959,737	$ 524,012
Operating Expenses:			
Operation:			
Fuel	66,775	45,199	29,450
Other	95,888	98,172	57,403
Maintenance	28,675	31,801	19,597
Depreciation and decommissioning	96,545	59,245	38,412
Taxes other than income taxes	27,198	23,688	7,568
Income taxes (Note 2)	201,195	233,881	118,815
Total	516,276	491,986	271,245
Operating Income	446,273	467,751	252,767
Other Income:			
Allowance for equity funds used during construction (Note 1)	225	972	120,508
Miscellaneous income and deductions — net	11,853	5,962	8,707
Income taxes — credit (Notes 1 and 2)	38,265	39,406	108,838
Total	50,343	46,340	238,053
Interest Charges:			
Long-term debt	273,781	314,297	350,946
Power purchase advances	—	802	24,256
Other — net	19,193	4,294	1,403
Allowance for borrowed funds used during construction (Note 1)	4,841	5,563	(103,852)
Total	297,815	324,956	272,753
Net Income	$ 198,801	$ 189,135	$ 218,067

System Energy Resources, Inc. For the Years Ended December 31	1987	1986	1985
		(In Thousands)	
Retained Earnings, January 1	$ 1,161,104	$ 971,969	$ 753,902
Add — Net Income	198,801	189,135	218,067
Retained Earnings, December 31 (Note 6)	$ 1,359,905	$ 1,161,104	$ 971,969

See Notes to Financial Statements.

STATEMENTS OF CASH FLOWS

System Energy Resources, Inc.
For the Years Ended December 31

	1987	1986	1985
		(In Thousands)	
Operating Activities:			
Net income	$ 198,801	$ 189,135	$ 218,067
Noncash items included in income:			
Depreciation	95,432	58,132	57,856
Deferred income taxes	64,992	87,729	71,619
Investment tax credits — net	(277)	(243)	(122)
Allowance for funds used during construction	4,616	4,591	(224,360)
Amortization of debt discount	5,556	2,624	862
Changes in:			
Accounts receivable	(14,827)	1,484	(78,799)
Accounts payable	(14,105)	10,327	19,941
Unamortized fuel expense	1,285	(1,169)	(1,691)
Taxes and interest accrued	(54,728)	64,015	(43,397)
Other current assets and liabilities	(33,560)	64,323	(36,243)
Increase in bonding trust arrangement	(101,202)	—	—
Change in future benefits related to AFDC	97,128	(57,523)	(23,587)
Increase in decommissioning trust	(2,774)	—	—
Other	3,975	(48,566)	(13,638)
Net cash flow from operating activities	250,312	374,859	(73,492)
Investing Activities:			
Construction expenditures	(24,194)	(40,782)	(335,656)
Allowance for funds used during construction	(4,616)	(4,591)	224,360
Nuclear fuel expenditures	(119,271)	(277)	(625)
Expenditures on suspended construction project	(10,403)	—	—
Net cash flow used by investing activities	(158,484)	(45,650)	(111,921)
Financing Activities:			
Proceeds from issuance of:			
First mortgage bonds	$ 300,000	$ 1,050,000	$ 100,000
Bank notes and other long-term debt	—	90,000	265,000
Proceeds from sale and leaseback of nuclear fuel	66,446	34,419	14,975
Retirement of first mortgage bonds	—	(324,265)	(54,235)
Retirement of bank notes and other long-term debt	(335,101)	(1,097,717)	(281,832)
Letter of credit escrow payments	(89,400)	(19,162)	—
Changes in short-term borrowings	158,000	—	(10,000)
Power purchase advance payments	—	(51,152)	(110,571)
Net cash flow from financing activities	99,945	(317,877)	(76,663)
Net change in cash and cash equivalents	191,773	11,332	(262,076)
Cash and cash equivalents at beginning of year	42,760	31,428	293,504
Cash and cash equivalents at end of year	$ 234,533	$ 42,760	$ 31,428
Supplemental disclosures of cash flow information:			
Cash paid during the year for:			
Interest (net of amount capitalized)	$ 291,910	$ 298,477	$ 209,741
Income taxes	$ 70,146	$ 49,854	—
Supplemental schedule of noncash investing and financing activities:			
Capital lease obligation recorded (Note 9)	$ 165,550	—	—

See Notes to Financial Statements.

1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

System Energy Resources, Inc. (Company), formerly Middle South Energy, Inc., is a wholly-owned subsidiary of Middle South Utilities, Inc. (MSU). The Company was created in 1974 to finance and construct certain base-load generating units for the operating subsidiaries of MSU.

The Company is engaged in the management, operation and maintenance of, and financing of its 90% ownership interest in, a two-unit nuclear generating station located near Port Gibson, Mississippi (Grand Gulf Station). The Grand Gulf Station is designed as two 1250 megawatt (MW) nuclear generating units. The Company sells capacity and energy from Unit No. 1 of the Grand Gulf Station (Grand Gulf 1) to Arkansas Power & Light Company (AP&L), Louisiana Power & Light Company (LP&L), Mississippi Power & Light Company (MP&L) and New Orleans Public Service Inc. (NOPSI), collectively referred to as the "System operating companies."

On July 28, 1986, the name of Middle South Energy, Inc. was changed to System Energy Resources, Inc. and, effective December 20, 1986, the Company assumed the primary responsibilities, previously assigned to MP&L, for the management, operation and maintenance of the Grand Gulf Station. On October 28, 1986, the Company changed the location of its principal business offices from New Orleans, Louisiana, to Jackson, Mississippi.

The Company and South Mississippi Electric Power Association (SMEPA) own undivided ownership interests of 90% and 10%, respectively, in the Grand Gulf Station. The Company records its investment associated with the Grand Gulf Station to the extent to which it owns and participates in the generating station.

The Company had no operating revenues or expenses prior to July 1, 1985. The Nuclear Regulatory Commission (NRC) issued a full power operating license for Grand Gulf 1 on August 31, 1984. This unit began commercial operation on July 1, 1985. Construction work on Unit No. 2 of the Grand Gulf Station (Grand Gulf 2) was suspended in September 1985.

System of Accounts

The accounts of the Company are maintained in accordance with the system of accounts prescribed by the Federal Energy Regulatory Commission (FERC).

Postretirement Benefits

The Company participates in an MSU System postretirement plan covering substantially all of its employees. The Company's policy is to fund pension costs in accordance with contribution guidelines established by the Employee Retirement Income Security Act of 1974 and to fund other postretirement plan costs as incurred.

Income Taxes

The Company joins its parent and affiliates in the filing of a consolidated Federal income tax return. Income taxes are allocated to the Company in proportion to its contribution to the consolidated taxable income. In addition, the Company files a consolidated Mississippi state income tax return with certain other System companies.

Allowance for Funds Used During Construction

In accordance with the regulatory system of accounts, the Company capitalizes, as an appropriate cost of utility plant, an allowance for funds used during construction (AFDC). Under this utility industry practice, construction work in progress on the balance sheet is charged and the income statement is credited for the approximate net composite interest cost of borrowed funds and for a reasonable return on the equity funds used for construction. This procedure is intended to remove from the income statement the effect of the cost of financing the construction program, and results in treating the AFDC charges in the same manner as construction labor and material costs. As non-cash items, these credits to the income statement have no effect on current cash earnings. After the property is placed in service, the AFDC charged to construction costs is recoverable from customers through depreciation provisions included in rates charged for utility service. During the first half of 1985, the Company used an accrual rate for AFDC based on a return on average common equity of 14% plus actual interest cost net of related income taxes. As a result of the FERC's decision on June 13, 1985, the 14% return on common equity rate was increased to 16% effective July 1, 1985. See Note 8, "Rate and Regulatory Matters," for information with respect to a settlement which, among other things, reduced the 16% rate of return on common equity to 14% retroactive to July 1, 1987.

AFDC attributable to Grand Gulf 1 ceased accruing as of July 1, 1985, the commercial operation date of the unit.

On September 18, 1985, the Mississippi Public Service Commission (MPSC) issued an Order Directing Suspension of Construction of Grand Gulf 2, which directed the Company and MP&L to suspend construction of Grand Gulf 2 as of the date of the Order. Following the issuance of the Order, the Company suspended construction of Grand Gulf 2 and ceased accruing AFDC on the unit effective September 18, 1985. See Note 7, "Commitments and Contingencies — Suspended Construction Project — Grand Gulf 2," and Note 8, "Rate and Regulatory Matters — Rate Activity — System Operating Companies."

Utility Plant, Depreciation and Decommissioning

Utility plant is stated at original cost. The cost of additions to utility plant includes contracted work, direct labor and materials, allocable overheads and AFDC. The costs of units of property retired are removed from utility plant and such costs plus removal costs, less salvage, are charged to accumulated depreciation. Maintenance and repairs of property, and the replacement of items determined to be less than units of property, are charged to operating expenses. Substantially all of the utility plant is subject to the lien of the Company's first mortgage bond indenture.

Depreciation on Grand Gulf 1 was computed using the units-of-production method for the initial twelve months of commercial operation (which began July 1, 1985) and, with FERC approval, for an additional six months thereafter. Subsequent to December 31, 1986, depreciation has been computed on a straight-line basis. Depreciation provisions on average depreciable property approximated 2.85% in 1987, 1.8% in 1986, and 2.3% in 1985. On October 30, 1986, the Company filed an application with the FERC, proposing a 3.1% straight-line depreciation rate, and the FERC initiated a proceeding, to determine the appropriate straight-line depreciation rate for Grand Gulf 1. On April 28, 1987, a settlement in principle was achieved which, among other things, decreased the depreciation rate in the Unit Power Sales Agreement from 3.10% to 2.85%, retroactive to January 1, 1987. Such settlement was approved by the FERC on September 15, 1987.

The Company is recovering approximately $1.1 million per year for nuclear plant decommissioning costs for Grand Gulf 1 and is depositing these monies in a tax qualified external fund held by a trustee. The Company was permitted by the FERC to recover these amounts based on studies of the estimated costs of decommissioning Grand Gulf 1.

Statement of Cash Flows

The Company has adopted Statement of Financial Accounting Standards (SFAS) No. 95, Statement of Cash Flows, and accordingly has presented the statements of cash flows for the years ended December 31, 1985, 1986, and 1987. For purposes of the statements of cash flows, the Company considers all highly liquid debt instruments, purchased with a maturity of three months or less, to be cash equivalents.

2 INCOME TAXES

Income tax expense (credit) consists of the following:

For the Years Ended December 31	1987	1986	1985
		(In Thousands)	
Current:			
Federal	$ 98,215	$ 106,989	$ (55,513)
State	—	—	(6,007)
Total	98,215	106,989	(61,520)
Deferred — net:			
Taxes capitalized in the financial statements	(152)	1,546	5,731
Liberalized depreciation	73,315	76,446	69,160
Test energy	50	27	(3,272)
Other	(8,221)	9,710	—
Total	64,992	87,729	71,619
Investment tax credit adjustments — net	(277)	(243)	(122)
Recorded income tax expense	$ 162,930	$ 194,475	$ 9,977
Charged to operations	$ 201,195	$ 233,881	$ 118,815
Credited to other income	(38,265)	(39,406)	(108,838)
Recorded income tax expense	162,930	194,475	9,977
Income taxes applied against the debt component of AFDC	(3,652)	(5,281)	98,589
Total income taxes	$ 159,278	$ 189,194	$ 108,566

Deferred income taxes are provided for differences between book and taxable income to the extent permitted by the FERC for ratemaking purposes. AFDC is excluded for purposes of determining taxable income.

The balance sheet account described as "future benefits related to AFDC" represents the tax benefits of the Company's portion of the consolidated Federal tax losses that are expected to be realized during the loss carryforward period. Such benefits are paid to the Company when realized in the consolidated return of MSU or are realized as reductions of income tax liabilities arising from the commercial operation of Grand Gulf 1. The income tax benefits realized in 1985 and 1987 amounted to approximately $10 million and $95 million, respectively. No benefits were realized in 1986. If not utilized to offset consolidated Federal taxable income, future benefits related to AFDC will expire in the years 1993 through 2000.

Investment tax credits allocated to the Company have been deferred and those relating to Grand Gulf 1 are being amortized based upon the average useful life of the related property. Unused investment tax credits at December 31, 1987 amounted to $137.9 million after the 35% reduction required by the Tax Reform Act of 1986. These credits may be applied against Federal income tax liabilities in future years. If not used, they will expire in the years 1992 through 2001.

The Alternative Minimum Tax (AMT) credit at December 31, 1987, was $1.3 million. This AMT credit can be carried forward indefinitely and will reduce regular income tax in the future.

In December 1987, the Financial Accounting Standards Board (FASB) issued SFAS No. 96, Accounting for Income Taxes, which is effective for years beginning after December 15, 1988. Under the liability method adopted by SFAS No. 96, deferred tax balances will be based on enacted tax laws at tax rates that are expected to be in effect when the temporary differences reverse. SFAS No. 96 expands the requirement to record deferred income taxes for all temporary differences that are reported in one year for financial reporting purposes and a different year for tax purposes. This will require the recognition of deferred tax balances for certain items not previously reflected in the financial statements, such as a deferred tax liability relating to AFDC.

It is expected that reductions in deferred taxes resulting from the lower corporate federal tax rates will be reflected as liabilities to customers since the Company's regulator may require any such savings to be passed on to the ratepayers. The impact of SFAS No. 96 on the financial position or results of operations of the Company has not yet been determined.

Total income taxes differ from the amounts computed by applying the statutory Federal income tax rate to income before taxes. The reasons for the differences are as follows:

For the Years Ended December 31	**1987**		1986		1985	
			(In Thousands)			
	Amount	% of Pre-Tax Income	Amount	% of Pre-Tax Income	Amount	% of Pre-Tax Income
Computed at statutory rate	**$ 144,692**	**40.0**	$ 176,461	46.0	$ 104,900	46.0
Increases (reductions) in tax resulting from:						
AFDC	**1,846**	**.5**	2,111	.5	(103,206)	(45.2)
Depreciation	**16,484**	**4.6**	11,337	3.0	7,845	3.4
State income taxes net of Federal income tax expense	**5,384**	**1.5**	5,184	1.4	961	.4
Other	**(5,476)**	**(1.5)**	(618)	(.2)	(523)	(.2)
Recorded income tax expense	**162,930**	**45.1**	194,475	50.7	9,977	4.4
Income taxes applied against the debt component of AFDC	**(3,652)**	**(.6)**	(5,281)	(1.4)	98,589	28.8
Total income taxes	**$ 159,278**	**44.5**	$ 189,194	49.3	$ 108,566	33.2

3 LINES OF CREDIT AND RELATED BORROWINGS

Prior to June 28, 1985, the Company had two revolving credit agreements with various banks providing for borrowings totaling $2,089 million. One agreement, for $1,711 million, was with a group of U.S. Banks (U.S. Bank Loan Agreement); the other agreement, with a group of Foreign Banks (Foreign Bank Loan Agreement), was for $378 million. On August 2, 1985, and August 9, 1985, respectively, the Foreign and U.S. Bank Loan Agreements were amended, effective as of June 28, 1985, to convert the borrowings thereunder to term loans. At December 31, 1987, the Company had outstanding borrowings of $247.6 million and $126.75 million, respectively, under the U.S. and Foreign Bank Loan Agreements. The loans with U.S. Banks have a scheduled maturity date of February 5, 1989, subject to mandatory semi-annual payments of $125 million due on the first day of each March and September, with the unpaid balance due on the maturity date. A portion of these semi-annual payments will be applied to an escrow account for the benefit of certain banks participating in the U.S. Bank Loan Agreement that provided a letter of credit in connection with the Series C Pollution Control Revenue Bonds (Series C Letter of Credit Banks). The uncollateralized amount needed to fund the escrow account was approximately $126.0 million at December 31, 1987. The scheduled maturity date for the loans with Foreign Banks is February 5, 1989, subject to mandatory semi-annual payments of $47.25 million to be made on February 5 and August 5 of each year.

In March 1986, the Foreign Bank Loan Agreement was amended to (1) increase the interest rate on borrowings thereunder by 1% effective from February 5, 1986, and (2) change certain provisions of the Foreign Bank Loan Agreement relating to Grand Gulf 2 such that prepayment of outstanding borrowings under this agreement would not be required for condemnation, abandonment or non-completion of Grand Gulf 2. These amendments relating to Grand Gulf 2 became effective in June 1986.

In January 1987, the Company prepaid $52.82 million of bank notes under the U.S. Bank Loan Agreement and $15 million under the Foreign Bank Loan Agreement and paid approximately $12 million into the escrow account for the benefit of the Series C Letter of Credit Banks. In addition, the Company paid in February 1987 the $47.25 million semi-annual installment due under the Foreign Bank Loan Agreement. On March 2, 1987, the Company paid the scheduled semi-annual installment of $125 million due under the U.S. Bank Loan Agreement, $35.1 million of which was paid into the escrow account.

Under its Foreign and U.S. Bank Loan Agreements, the Company was required to make scheduled payments of principal in the amounts of $47.25 million on August 5, 1987, to the Foreign Banks and $125 million (including $42.2 million to be paid into the escrow account for the Series C Letter of Credit Banks) on September 1, 1987, to the U.S. Banks. The Company had been delayed in effecting permanent financing due to uncertainties surrounding the System operating companies' retail rate relief with respect to Grand Gulf 1 and uncertainties associated with the decision of the United States Court of Appeals for the District of Columbia Circuit (D.C. Circuit) reversing, in part, and remanding the FERC's decision issued on June 13, 1985, (June 13 Decision) affirming the allocation of capacity and energy among the System operating companies.

In view of the above-mentioned uncertainties, the delay in effecting permanent financing for the Company and the need for the Company and the Middle South System to conserve available cash resources, the Company determined to seek deferrals from the Foreign and U.S. Banks of the payments scheduled to be made to them on August 5 and September 1, 1987, respectively. The Company obtained the consent of the Foreign Banks to initially defer its scheduled payment of $47.25 million from August 5 to August 31, 1987. In connection therewith, the Company agreed to pay the Foreign Banks an additional 1% per annum interest on the deferred amount through August 31, 1987, and a fee of 1/8 of 1% on outstanding borrowings under the Foreign Bank Loan Agreement, and not to declare or pay any dividends on common stock until the deferred amount is paid in full.

With the consent of its creditor banks, the Company further deferred the $47.25 million installment due to the Foreign Banks and deferred the $125 million installment due to the U.S. Banks (such deferred installments herein referred to collectively as "Deferred Installments"), in each

case to not later than December 15, 1987. In connection therewith, the Company agreed to pay the Foreign and U.S. Banks an additional 1% per annum interest on the Deferred Installments and to pay the U.S. Banks a fee based upon arrangements similar to those previously agreed upon between the Company and the Foreign Banks. In addition, the Company agreed not to pay any dividends on its common stock to MSU until all loans outstanding under the U.S. and Foreign Bank Loan Agreements are fully paid, the scheduled final maturities being in February 1989. On November 25, 1987, permanent financing was obtained by the Company, and on November 25, 1987, the Deferred Installments were paid.

As of December 31, 1987, the Company had two separate "interest rate swap" agreements, each with a bank, through February 1989 for $78.75 million and $63 million. The Company has agreed to make semi-annual interest payments based upon an 11.5% and 11.16% fixed rate, respectively, in exchange for semi-annual interest payments by the banks based upon the London Interbank Offered Rate (LIBOR). These agreements serve to offset fluctuations in variable rates to be paid under the Company's Foreign Bank Loan Agreement. They do not change the Company's obligations to the Foreign Banks for interest payments of LIBOR plus 2%.

The Company is subject to limitations on the maximum amount of short-term borrowings outstanding under both the Public Utility Holding Company Act of 1935 (Holding Company Act) and the terms of its bank loan agreements. The Company is currently authorized by the Securities and Exchange Commission (SEC) to effect short-term borrowings in an aggregate amount outstanding at any one time of up to 10% of its capitalization. The Company is limited by the terms of its bank loan agreements to short-term borrowings in an aggregate amount not exceeding the lesser of 5% of capitalization (approximately $234.5 million at December 31, 1987) or $200 million. The Company does not have any bank lines of credit currently available. Short-term borrowings of the Company up to the authorized amount can be effected through the System Money Pool (Money Pool), which allows certain System companies to borrow from, or lend to, certain other System companies, subject to the availability of funds which at any particular time may be limited.

Prior to 1987, the Company participated only as a lender/investor with certain other companies of the Middle South System in the Money Pool. Effective January 1, 1987, the Money Pool arrangement was amended to allow the Company to borrow funds, subject to its maximum authorized level of short-term borrowings and limitations in its bank loan agreements, as well as lend/invest an aggregate amount of up to $10 million through the Money Pool, in accordance with limitations in its bank loan agreements. At December 31, 1987, the Company had no outstanding borrowings from the Money Pool.

On April 30, 1987, the Company issued and sold $158 million of unsecured promissory notes to a group of domestic and foreign institutional investors. Proceeds from these notes were used to repay the outstanding borrowings from the Money Pool. Such notes, which matured and were paid January 25, 1988, bore interest at 9 1/2% per annum through October 27, 1987, when the rate was reset to 9.6875% per annum for the remainder of the term.

(Note three, continued)

The short-term borrowings and the interest rates (determined by dividing applicable interest expense by the average amount borrowed) for the Company were as follows:

For the Years Ended December 31	1987	1986	1985
		(In Thousands)	
Lines of credit	—	—	—
Maximum borrowing	$ 188,100	—	$ 10,000
Year-end borrowing	$ 158,000	—	—
Average borrowing:			
Lines of credit	—	—	$ 1,342
Unused short-term notes	$ 106,488	—	$ 4,275
Associated companies	$ 22,790	—	—
Average interest rate:			
During period—			
Lines of credit	—	—	10.4%
Unused short-term notes	9.6%	—	9.4%
Associated companies	6.3%	—	—
At end of period—			
Lines of credit	—	—	—
Unused short-term notes	9.7%	—	—
Associated companies	—	—	—

There were no changes in the number of shares of the Company's common stock during the years 1987, 1986 and 1985. It is expected that the Company's Articles of Incorporation will be amended in connection with any issuance of preferred stock to effect a split of its common stock 100 to 1.

5 LONG-TERM DEBT

The long-term debt of the Company at December 31, 1987 and 1986 was as follows:

December 31	1987	1986
	(In Thousands)	
First Mortgage Bonds:		
Due 2000, 16% Series	$ 300,000	$ 300,000
Due 2000, 15 3/8% Series	100,000	100,000
Due 2000, 11% Series	300,000	300,000
Due 1991, 9 7/8% Series	300,000	300,000
Due 1996, 10 1/2% Series	250,000	250,000
Due 2016, 11 3/8% Series	200,000	200,000
Due 1994, 14% Series	200,000	—
Due 1992, 14.34% Series	100,000	—
Total	1,750,000	1,450,000
Bank Notes (Note 3):		
Domestic bank line—		
Due 1988-1989, at 110% of the sum of prime and 1 %	247,599	473,200
Foreign bank line—		
Due 1988-1989, at LIBOR plus 2%	126,750	236,250
Total	374,349	709,450
Pollution Control Revenue Bonds:		
Claiborne County, Mississippi—		
Due 2013, at 7.0% adjustable/fixed rate	49,500	49,500
Due 2014, at 5.25% adjustable/fixed rate	27,100	27,100
Due 2015, at 8.25% adjustable/fixed rate	206,000	206,000
Due 2015, at 12.5%	44,000	44,000
Due 2016, at 9.5%	90,000	90,000
Total	416,600	416,600
Unamortized discount on debt	(35,617)	(32,201)
Total Long-Term Debt	2,505,332	2,543,849
Less—Amount due within one year	260,177	277,025
Long-Term Debt Excluding Amount Due Within One Year	$ 2,245,155	$ 2,266,824

(Note five, continued)

The Pollution Control Revenue Bonds due 2015 at 12.50% and those due 2016 at 9.50% are collateralized by $47.2 million and $95.6 million, respectively, of non-interest bearing first mortgage bonds. The Pollution Control Revenue Bonds due 2013 currently at 7.0% (Series A), those due 2014 currently at 5.25% (Series B), and those due 2014 currently at 8.25% (Series C) are secured by letters of credit which terminate in December 1988, June 1989, and December 1989, respectively. See Note 7, "Commitments and Contingencies — Capital Requirements and Financing."

In connection with the Series C Pollution Control Revenue Bonds due 2014, certain banks that participated in the U.S. Bank Loan Agreement provided a letter of credit requiring the Company to make semi-annual payments into an escrow account. The uncollateralized amount needed to fund the escrow account was approximately $126.0 million at December 31, 1987.

Sinking fund requirements and maturities for the ensuing five years for the Company's long-term debt at December 31, 1987 were as follows:

	Cash Sinking Fund	Maturities*
	(In Thousands)	
1988	—	$ 260,177
1989	$ 53,500	$ 114,172
1990	$ 53,500	—
1991	$ 68,500	$ 300,000
1992	$ 68,500	$ 100,000

**Excludes remaining requirements for escrow payments of $126.0 million through 1989 for the benefit of the Series C Letter of Credit Banks.*

Substantially all of the Company's utility plant is subject to the lien of its first mortgage bond indenture.

6 RETAINED EARNINGS

The provisions of certain of the Company's financing agreements and its first mortgage bond indenture restrict the amount of retained earnings available for cash dividends on common stock. Under its mortgage, the Company may not declare dividends, other than stock dividends, or make other distributions on or acquisitions of, its stock (except where concurrently certain contributions or stock proceeds are received) unless the Company is not in default under certain of its financing agreements, and the sum of certain indebtedness does not exceed 65% of adjusted capitalization. In addition, banks which are parties to the Company's U.S. and Foreign Bank Loan Agreements voted in 1986, pursuant to such Agreements, to deny the Company the right to pay any cash dividends on common stock. Accordingly, prior to January 1987, all of the

Company's retained earnings were restricted as to the payment of cash dividends on common stock.

The provisions of the U.S. and Foreign Bank Loan Agreements allowed the Company the right to pay cash dividends on common stock upon making sufficient prepayments to the U.S. Banks to reduce the amount owing under the U.S. Bank Loan Agreement at maturity to $125 million or less. On January 5, 1987, the Company made a payment under the U.S. Bank Loan Agreement in the amount of $65 million, which was sufficient to reduce the obligations thereunder to an amount which, among other things, cancelled the suspension pursuant to the Bank Loan Agreements of the Company's right to pay common stock dividends. However, in connection with the subsequent deferral in August 1987 of the scheduled payments under the Foreign and U.S. Bank Loan Agreements, the Company agreed not to declare or pay any dividends on common stock until all loans outstanding under these Agreements are fully paid, the scheduled final maturities being in February 1989. See Note 3, "Lines of Credit and Related Borrowings," for information with respect to the deferral of scheduled payments under the Foreign and U.S. Bank Loan Agreements.

After these final maturities are paid, the Company would continue to be limited in the payment of cash dividends on common stock by provisions of the Foreign Bank Loan Agreement and Reimbursement Agreements for its Series A and B Pollution Control Revenue Bonds. Under these Agreements, the Company is presently limited in the amount of dividends it may pay on its capital stock (other than dividends payable solely in shares of common stock and dividends payable in cash where, concurrently, the Company receives a capital contribution or sells shares of its common stock) in an amount equal to its accumulated net income for the period July 1, 1985, to the date of the payment. Such amount was approximately $498.4 million at December 31, 1987. The Company has paid no dividends on its capital stock to date. In the event the Company experienced a loss that exceeded such accumulated net income, less the sum of certain dividends paid, if any, since July 1, 1987, dividends could not be paid until such a deficit was restored by subsequently earned net income, except where concurrently the Company receives a capital contribution or sells shares of its common stock.

7 COMMITMENTS AND CONTINGENCIES

General

As of December 31, 1987, the Company's most significant commitments and contingencies related to (1) disputes involving rate structures implemented by the System operating companies which have changed, are in litigation (in particular, the outcome of MP&L's appeal to the United States Supreme Court from the Mississippi Supreme Court's February 25, 1987 decision (February 25 Decision) reversing and remanding a retail rate order of the MPSC), or have been or currently are subject to prudence reviews or disallowances (in particular, the recent action of the Council of the City of New Orleans, Louisiana (Council) imposing an additional prudence disallowance of $135 million on NOPSI, which has had a material adverse effect on NOPSI's financial condition and, if not reversed, could render NOPSI insolvent in a short period of time), (2) the status of Grand Gulf 2, construction of which has been suspended,

(Note seven, continued)

(3) a FERC audit of the Company and the Grand Gulf Station, and (4) the continuing controversies over the Grand Gulf Station and the allocation of capacity and energy from Grand Gulf 1 to the System operating companies.

The Council has conducted a prudence inquiry into NOPSI's involvement in Grand Gulf 1. On February 4, 1988, the Council adopted a resolution requiring NOPSI to write off and not to recover from its retail electric customers $135 million of its deferred Grand Gulf 1 costs, in addition to the $51.2 million of such costs that NOPSI had previously agreed to absorb in its March, 1986 rate settlement. NOPSI is seeking relief in the courts from this finding by the Council of alleged imprudence. However, as a result of NOPSI's inability to obtain injunctive relief that would stay the effectiveness of the Council's action, NOPSI was required to record the write-off in 1987, thereby resulting in a loss for the year and a deficit in its retained earnings at December 31, 1987. The ultimate consequences of the Council's actions, should they remain in effect, are that NOPSI's ability to obtain the requisite funds to meet its ongoing obligations, including its contractual obligations to the Company in respect of the Grand Gulf Station, will be severely impaired and NOPSI could be rendered insolvent in a short period of time, perhaps as early as the second quarter of 1988. See "Potential Debt Acceleration, Bankruptcy and Middle South System Viability" below.

As a condition of a stay obtained by MP&L while it pursues an appeal of the February 25 Decision, MSU and the Company have unconditionally co-guaranteed (in the amount of approximately $206 million as of June 30, 1987) a corporate undertaking by MP&L to "self-insure" amounts previously collected under its rate plan from September 1985 through June 1987. In addition, the Company has been depositing each month into a trust account for the benefit of MP&L's ratepayers an amount equal to MP&L's monthly cash collections from its customers for Grand Gulf 1 costs from June 1, 1987, to the date of final adjudication of MP&L's appeal to the United States Supreme Court. Through March 15, 1988, the Company expects that payments into the trust account under this requirement will approximate $138.5 million, and such payments are estimated to average approximately $14 million per month through June 1988, at which time it is expected that a decision shall have been rendered by the United States Supreme Court in MP&L's appeal. On September 10, 1987, the SEC approved the participation by MSU and the Company in the bonding requirements of the Mississippi Supreme Court. On September 14, 1987, MP&L filed with the Mississippi Supreme Court its corporate undertaking for the possible refund of collections from September 20, 1985 through June 30, 1987 (Past Collections), the corporate guarantee of the Company for Past Collections, the corporate guarantee of MSU for Past Collections, the Company's corporate undertaking for the possible refund of collections after May 31, 1987, a Trust Agreement between the Company and Trustmark National Bank, under which the Company began making deposits equivalent to MP&L's cash collections beginning as of June 1, 1987, and the corporate undertaking of MP&L for refund of all collections after June 30, 1987. On September 17, 1987, the Mississippi Supreme Court entered an order approving this bonding arrangement. To the extent that either the Company or MSU makes payments to discharge MP&L's obligation to make refunds to its customers as a result of an adverse final judicial determination of MP&L's appeal of the February 25 Decision, the Company and/or MSU, as the case may be, will have an immediate right of reimbursement from MP&L. The Company has agreed, at the request of its creditor banks, to demand immediate reimbursement from MP&L on account of all amounts paid by the Company (whether directly or from monies placed in trust) on behalf of MP&L and to promptly take all reasonable actions necessary to collect such amounts from MP&L.

On October 5, 1987, the United States Supreme Court decided to hear full argument of MP&L's appeal of the February 25 Decision but postponed further consideration of the United States Supreme Court's jurisdiction to the hearing of the case on the merits. The stay granted by the United States Supreme Court on June 1, 1987, remains in effect. Accordingly, MP&L is continuing to collect its Grand Gulf 1 rates, subject to refund, pending the Court's decision. Oral argument before the United States

Supreme Court was held on February 22, 1988. It is expected that the case will be decided by the end of June 1988. The Company cannot predict the outcome of this matter or whether the current rate structure of MP&L will remain in effect. Without adequate rates to recover Grand Gulf 1 charges, MP&L could suffer such liquidity constraints that it would, in a short period of time, be unable to meet its contractual obligations to the Company with respect to the Grand Gulf Station.

Potential Debt Acceleration, Bankruptcy and Middle South System Viability

Adverse regulatory or judicial decisions involving the System operating companies' retail rate structures relating to their recovery of Grand Gulf 1 costs could produce varying consequences that could jeopardize the Middle South System, including those set forth below.

If the United States Supreme Court, on the appeal to it of the February 25 Decision, renders any decision adverse to the Middle South System's position, the application of the doctrine of federal preemption could be severely undermined. The doctrine of federal preemption is necessary in order to secure implementation of the Company's federally mandated wholesale rates through the retail structures of the System operating companies.

Without adequate rates to recover Grand Gulf 1 charges, MP&L and NOPSI could suffer such liquidity constraints that they would, in a short period of time, be unable to meet their contractual obligations to the Company with respect to Grand Gulf 1 and could be rendered insolvent.

Failure of any System operating company to maintain its current rate structure, or to meet its contractual obligations to the Company with respect to the Grand Gulf Station, could, under certain agreements relating to the Company's indebtedness (but only upon further action by the requisite percentage of the Company's creditors), lead to acceleration of such indebtedness unless (1) waivers were obtained, (2) the debt were restructured or (3) other arrangements could be negotiated. In addition, in the absence of such waivers, debt restructuring or other negotiated arrangements, acceleration of such indebtedness could occur if a System operating company were rendered insolvent as a result of a substantial reduction in rates. Given the substantial amount of the Company's debt, it would not be able to meet its obligations, if accelerated. Under the Company's financing agreements, the System operating companies would not be responsible for the payment of the Company's accelerated obligations if the Company could not meet them. MSU, with its financial resources currently limited, would not at this time be in a position to satisfy the Company's obligations, if accelerated.

Certain of System Fuels, Inc.'s (SFI) financing agreements and leases may require payments by the System operating companies, MSU, or the Company in the event SFI's obligations under such agreements are accelerated as a result of the insolvency of a System operating company and SFI is unable to meet these obligations or to otherwise satisfy these obligations through the sale of the collateral securing such obligations. In addition, insolvency of a System company would affect the terms of financing, including an increase in cost of financing, or could preclude financing, for other Middle South System companies.

In the event of any of the foregoing adverse developments, the continuing viability of the Middle South System would be placed in jeopardy, and it could be difficult to avoid a bankruptcy filing by the Company or other affected Middle South System companies. In this connection, the Company and certain Middle South System companies have each retained independent special counsel experienced in bankruptcy matters and have been studying the relief and protection that might be available to them under Chapter 11 of the United States Bankruptcy Code. While no decisions with regard to bankruptcy filings have yet been made, it must be recognized, in light of the risks discussed herein, that future events, either singly or in combination, may result in such adverse changes in business circumstances or such a decrease in liquidity as to make it prudent for the Company or one or more other affected Middle South System companies to file a petition for reorganization under Chapter 11. Many of these future events are beyond the control of the Middle South System.

The effects of a bankruptcy proceeding involving one or more Middle South System companies and the extent of the jurisdiction of the SEC

(Note seven, continued)

under the Holding Company Act and of other federal and state regulatory bodies over the bankrupt entity or entities and over any other Middle South System companies not in bankruptcy cannot be predicted. In any event, security holders and creditors of the company or companies involved in bankruptcy proceedings could be significantly affected by such proceedings. The proceedings could last for years, and there are many uncertainties as to how provisions of the law would be applied. Rights and remedies of security holders and creditors may be altered, denied or limited under such laws. The obligations of MSU and the System operating companies under the Capital Funds Agreement and the Availability Agreement, respectively, and the assignments thereof, could also be litigated and possibly reduced or eliminated. There could be no assurance that any creditors would be able to recover the full amount of their claims, and securities and stock with inferior rights could be substituted for those with priorities. Moreover, it is uncertain as to whether the bankrupt entity or entities could be successfully reorganized in their present form, whether the current relationships between and among various Middle South System companies would be significantly altered or whether the Middle South System would continue to exist in its present form after bankruptcy of one or more Middle South System companies.

Capital Requirements and Financing

The Company's capital requirements noted below are based on certain assumptions and judgments with respect to, among other things, the outcome of pending regulatory and judicial proceedings. If future events vary significantly from these assumptions, additional capital requirements could result.

The Company will require approximately $613.9 million from internal and external sources for the period 1988 through 1990 to refinance maturing indebtedness (excluding $158 million of unsecured short-term notes which matured and were paid in January 1988), to meet sinking fund requirements and to finance its other capital requirements. Furthermore, the Company may enter into arrangements for the sale and leaseback of property in which the proceeds from such transactions could be used to retire debt at par. In addition, the Company's nuclear fuel leases may terminate during this period if the credit lines supporting the nuclear fuel leases terminate, as scheduled. It is currently assumed that either the credit lines will be extended or that alternative credit lines will be arranged. To the extent, however, that this does not occur, additional capital requirements of up to $215 million could result. The Company also estimates that approximately $0.4 million will be required during the period 1988-1990 to acquire nuclear fuel in addition to amounts assumed to be financed under lease. Further, in connection with MP&L's bonding order from the Mississippi Supreme Court, the Company is required to deposit each month into a trust account for the benefit of MP&L's ratepayers an amount equal to MP&L's monthly cash collections from its customers for its Grand Gulf 1 obligations from June 1, 1987, until MP&L's current appeal to the United States Supreme Court is resolved. Through March 15, 1988, the Company expects that payments into the trust account under this requirement will approximate $138.5 million, and such payments are estimated to average approximately $14 million per month through June 1988, at which time it is expected that a decision shall have been rendered by the United States Supreme Court in MP&L's appeal. The Company's 1988 capital requirements assume that MP&L's appeal to the United States Supreme Court will be resolved on or before June 30, 1988, and that cash deposited by the Company will be returned to the Company upon successful completion of the appeal.

The Series A, B and C Pollution Control Revenue Bonds are secured by letters of credit which terminate on December 11, 1988, June 11, 1989, and December 11, 1989, respectively, at which time such bonds will be remarketed. The Company anticipates that either the existing letters of credit will be extended, new letters of credit will be issued or the Company's financial condition will permit remarketing without letters of credit. In the event the remarketing is unsuccessful, the Company would require additional funds of up to approximately $50 million and approximately $28 million within one year of the respective termination

dates in order to repay amounts advanced by banks under the letters of credit to enable the Company to reacquire the Series A and B Pollution Control Revenue Bonds, respectively. In the event the Series C Pollution Control Revenue Bonds cannot be remarketed or the letter of credit extended or replaced, the amount held in escrow for the benefit of the Series C Letter of Credit Banks will be used to repay amounts advanced by banks under the letter of credit to reacquire the Series C Pollution Control Revenue Bonds. See Note 5, "Long-Term Debt," for additional information.

During 1987, the Company was delayed in effecting permanent financing due to uncertainties surrounding the System operating companies' retail rate relief with respect to Grand Gulf 1 and uncertainties associated with the decision of the D.C. Circuit reversing, in part, and remanding the June 13 Decision. See Note 8, "Rate and Regulatory Matters — Unit Power Sales Agreement," for more information regarding the June 13 Decision. However, the Company's ability to finance was enhanced by the United States Supreme Court's October 5, 1987, decision to hear full argument of MP&L's appeal of the February 25 Decision. As a result, the Company issued and sold $200 million of First Mortgage Bonds, 14% Series due 1994, through a public offering on November 24, 1987, and on December 1, 1987, the Company closed a private placement of $100 million of First Mortgage Bonds, 14.34% Series due 1992. The proceeds from these sales and internally generated funds were used to repay amounts deferred under the U.S. and Foreign Bank Loan Agreements, as well as the $158 million of unsecured short-term notes which matured in January 1988, and for other corporate purposes.

In addition, in February 1988, an agreement was entered into by the Company for the sale and leaseback of up to $50 million of the unleased nuclear fuel on its balance sheet. The lease extends for one year with monthly extensions thereafter until notice is given by either party thereto. Also, in February 1988, the Company entered into an arrangement for the sale of certain of its customer accounts receivable during the period February 29, 1988, through May 16, 1988. The terms of this arrangement provide for the periodic sale by the Company of up to approximately $52.6 million through March 15, 1988, and up to approximately $38.4 million thereafter of certain of its customer accounts receivable, including all collections relating thereto, without recourse to the Company. This arrangement is terminable by either party upon thirty days written notice.

Subsequent to the above financing arrangements, the Company anticipates that its projected cash flow for the period 1988-1990 will enable it to satisfy its cash requirements from internal sources and that no additional funds will be required from external sources for this period. However, many uncertainties continue to confront the Company and the Middle South System, and, depending upon the ultimate resolution of such uncertainties and the effects thereof upon the Company and the Middle South System, the Company may be required to obtain funds from external sources. If the Company is unable to obtain sufficient funds from external sources on a timely basis, the Company could develop such liquidity constraints that its ability to meet its obligations to its creditors might be impaired, which could lead to acceleration of the maturity of the Company's indebtedness (but only upon further action by the requisite percentage of the Company's creditors) unless waivers were obtained, the debt were restructured or other arrangements could be negotiated.

In connection with the Grand Gulf Station, MSU has undertaken, to the extent not obtained by the Company from other sources, to furnish, or cause to be furnished to the Company, sufficient capital for construction and operation and related purposes. Through December 31, 1987, MSU had invested $789.4 million in the common stock of the Company.

At December 31, 1987, the Company estimated construction expenditures (excluding nuclear fuel) of approximately $44.7 million in 1988, $43.3 million in 1989 and $44.1 million in 1990 in connection with its 90% interest in the Grand Gulf Station. Grand Gulf 1 expenditures are estimated to be (including minimal amounts of AFDC) $31.9 million in 1988, $30.7 million in 1989 and $29.9 million in 1990. The above construction expenditures assume no activities at Grand Gulf 2 except for demobilization and suspension. Through December 31, 1987, the Company had invested $4,274 mil-

(Note seven, continued)

lion (excluding nuclear fuel) in the Grand Gulf Station. The Company estimates, pending a final review of the cost allocation between the two units, that of this total, $3,384 million was invested by the Company in Grand Gulf 1 and $890 million in Grand Gulf 2.

Suspended Construction Project — Grand Gulf 2

As of December 31, 1987, the Company had invested approximately $890 million in Grand Gulf 2 (including approximately $392 million of AFDC), which was approximately 34% complete based on the estimated man-hours needed to complete the unit.

In September 1985, following an order of the MPSC, the Company suspended construction activities at Grand Gulf 2 and ceased accruing AFDC on the unit. Since that time, the Company has limited expenditures to only those activities which are absolutely necessary for suspension and demobilization of the unit. A special group of Middle South System officials and outside consultants completed in late November 1986 its evaluation and review of Grand Gulf 2. Among the possibilities evaluated were (1) cancellation of the unit, (2) continued suspension of construction on the unit through 1989 or beyond when future load and energy requirements are more definite and the Middle South System's financial capabilities are expected to be less restricted, and (3) conversion of the unit to an alternative fuel source. In December 1986, the Company's Board of Directors (with the MSU Board of Directors concurring) adopted the group's recommendation that suspension of construction be continued and that a further decision be made by 1990 on the future status of Grand Gulf 2 in light of alternatives available at that time. During the period of suspension, the energy needs of the region served by the Middle South System, as well as some of the uncertainties surrounding the costs of constructing nuclear power plants, should be further clarified.

Under the Foreign Bank Loan Agreement, the Company has covenanted to limit capital expenditures (other than those required by regulation) to not in excess of $80 million per annum in the aggregate. Unless waived, this covenant would preclude resumption of full construction on Grand Gulf 2 prior to 1989.

During the period of continued suspension, the Company's expenditures on Grand Gulf 2 will be limited, and it will continue not to accrue AFDC on its investment in the unit. Consequently, during the suspension period, the increase in the Company's investment in Grand Gulf 2 will be limited and the Company will forego any return on this investment.

The Company will continue, during the suspension period, to evaluate various alternatives for the future of Grand Gulf 2 and will also continue to assess whether certain equipment or facilities should continue to be carried at their full cost. Any determination that the value of the Company's investment should be reduced, and the amount of any such reduction written off, could adversely affect various companies in the Middle South System. The Company believes, however, that it is justified in carrying Grand Gulf 2 at its full value because the property currently comprising Grand Gulf 2 is of the same design as that of Grand Gulf 1 and is being properly maintained and is therefore suitable for its intended purpose. Certain issues relating to the value of the Company's investment in Grand Gulf 2 also exist in connection with an audit by the FERC of the Company and the Grand Gulf Station discussed below.

As a result of the decision of the Company's Board of Directors with respect to continuation of suspension of construction, the Company does not intend to make an application to the FERC during the period of suspension with respect to the recovery through rates of the Company's investment in Grand Gulf 2.

While the Company believes that all of its investment to date in Grand Gulf 2 has been prudent, in connection with any subsequent decision as to the value of Grand Gulf 2 or the ultimate decision with respect to the future of Grand Gulf 2, the Company will, at an appropriate time, make a determination as to the appropriate recovery of its investment. In making such a determination, the Company would consider, among other things, the regulatory environment generally, and legal standards then applicable. Any action to seek recovery of Grand Gulf 2 costs would likely involve a filing by the Company with the FERC requesting such recovery over a period of years through charges to the System operating companies, and related filings by the System operating companies before state or local regulatory authorities to recognize

the FERC-allowed charges in retail rates. In view of the controversies over the Grand Gulf Station, including the adverse reaction of various rate regulatory bodies to allocation of costs, and regulatory uncertainties, including rate-making, attendant to a delay in the decision as to the future of Grand Gulf 2, there can be no assurance that the full cost of Grand Gulf 2 will be recovered or as to the timing of any recovery. As was the case with Grand Gulf 1, proceedings before the FERC and, with respect to recognition in retail rates of FERC-approved rates, before state or local regulatory authorities, could be protracted and strongly contested on various grounds, including imprudence. If costs associated with Grand Gulf 2 were allocated to the System operating companies and they were unable to recover these costs from their customers, the System operating companies' financial condition could be materially and adversely affected. Any nonrecovery of the Company's investment in Grand Gulf 2 would result in a charge against earnings for any unrecoverable investment when that event becomes probable. In the event such a charge were substantial, the financial condition of the Company would be materially and adversely affected (although its cash position would not be adversely affected), and the Company's ability to pay dividends on its capital stock could be impaired. See Note 6, "Retained Earnings," for further information regarding these restrictions. Also, reference is made to "Statements of Financial Accounting Standards Nos. 71 and 90" below for information concerning accounting standards which address the accounting treatment of issues similar to those discussed herein.

During the period to 1990, certain issues, as described above, could cause a decrease in the valuation of the investment in Grand Gulf 2. Failure to obtain rate relief for all or a substantial portion of the cost of Grand Gulf 2 could have a material and adverse effect upon the financial condition of the Company, MSU and possibly the System operating companies, depending upon, among other things, the timing of the realization of any such loss.

In January 1988, the FERC issued an order which modified its policy regarding recovery of cancelled or abandoned plant costs by utilities subject to its jurisdiction. The revised policy provides for a "50/50 sharing" of prudently incurred costs of a cancelled plant between the owner and the ratepayers, whereby 50 percent of the prudently incurred costs of the cancelled plant would be amortized and recovered from ratepayers over the expected life of the plant as if it had been completed. The currently unamortized portion of such amount would also be included in rate base thereby allowing for a return thereon. The remaining 50 percent of prudently incurred costs would be written off.

In the third quarter of 1985, SMEPA, which has a 10% ownership interest in Grand Gulf 2, ceased making payments for its proportionate share of Grand Gulf 2 costs incurred subsequent to July 31, 1985. Effective February 7, 1986, SMEPA and the Company adopted a settlement agreement. Under the terms of the settlement agreement, SMEPA will pay its proportionate share of the Grand Gulf 2 costs incurred subsequent to July 31, 1985, and future costs for suspension and demobilization of the unit up to a maximum of $4.951 million but will no longer be obligated to pay costs of construction on Grand Gulf 2 should construction of the unit resume. Any Grand Gulf 2 costs applicable to SMEPA's interest in excess of this amount would be paid by the Company. Should the Company decide to resume full construction of Grand Gulf 2, SMEPA will have the option of having refunded to it all payments made under the settlement agreement for costs incurred subsequent to July 31, 1985, which could result, if necessary, in the periodic adjustment of SMEPA's and the Company's ownership interests in proportion to their respective investments in Grand Gulf 2. The settlement agreement relates solely to Grand Gulf 2 and does not apply to SMEPA's ownership interest or investment in Grand Gulf 1.

FERC Audit

The FERC has performed an audit of the Company and the Grand Gulf Station as part of its regulatory function in auditing utilities subject to its jurisdiction. The audit report, which pertains to the period from the Company's inception through December 31, 1985, was issued on June 18, 1987. In the report, the FERC Staff states, among other things, that the Grand Gulf Station's AFDC is overstated by $152.8 million ($120.7 million relating to Grand Gulf 1 and $32.1 million relating to Grand Gulf 2) because the "AFDC calculation failed to take into account all cost-free capital generated by SERI [the Company] expenditures

(Note seven, continued)

and claimed on consolidated income tax returns." The FERC Staff recommends that the Company record an accounting entry to charge the alleged AFDC overstatement against net income, recompute billings to customers since July 1, 1985, to reflect adjusted plant and equity balances, and refund, with interest, the difference between the recomputed billings and amounts previously charged customers. Further, the FERC Staff recommends that $345.6 million of "Recoverable Taxes" (classified on the Company's records as "Future Benefits Related to AFDC"), representing a significant portion of the Company's unrealized recorded income tax benefits, should be reclassified to "Accounts Receivable From Associated Companies," the net effect of which would be a $270.0 million reduction of Grand Gulf 1's rate base. The Staff recommends that the Company refund, with interest, the change in billings since July 1, 1985, due to this rate base reduction.

The Company has strongly disagreed with the Staff's position, asserting that the Staff's position is in violation of the SEC's tax allocation regulations applicable to holding company systems and contrary to the FERC's own accounting rules. Pursuant to a FERC Order Establishing Hearing Procedures, an administrative law judge (ALJ) held a prehearing conference on October 20, 1987, at which a procedural schedule for the case was established. A hearing has been set for May 16, 1988. Various parties, including the Arkansas Public Service Commission (APSC), the Louisiana Public Service Commission (LPSC), the MPSC and the Council have intervened in this proceeding.

If the Staff's findings are ultimately sustained, the resulting charges against net income and refund requirements would have a significant material adverse impact on the Company. The Company estimates that as of December 31, 1987, the impact on net income could be as high as approximately $290 million (net of tax effect), and the Company could be obligated to refund approximately $250 million, including interest, to its customers. In addition, the Staff's proposed adjustments would adversely impact the Company's prospective net income, earnings coverages and cash flow. The Company cannot predict the ultimate outcome of the examination.

Statements of Financial Accounting Standards Nos. 71 and 90

The accounting standards relating specifically to public utilities and certain other regulated enterprises are set forth in SFAS Nos. 71 and 90. SFAS No. 90, Regulated Enterprises — Accounting for Abandonments and Disallowances of Plant Costs, was issued by the FASB in December 1986 as an amendment of SFAS No. 71. It provides that, when an abandonment of a plant or a disallowance of costs with respect to a newly completed plant becomes probable, the following amounts, net of related tax benefits, would be reported either by restating the appropriate prior years' financial statements or by charging such amounts against current income: (1) the cost of an abandoned plant in excess of the present value of estimated recoveries or (2) the amount of a partial disallowance by regulators of a recently completed plant for ratemaking purposes. The new statement is effective for fiscal years beginning after December 15, 1987, with retroactive application for prior transactions. SFAS No. 90 will not have any current effect upon the Company in light of the decision to continue suspension of Grand Gulf 2 (see above). The provisions of SFAS No. 90 would apply should the Company decide to abandon Grand Gulf 2.

Shareholder Litigation

In 1985, MSU, certain other Middle South System companies, including the Company, and individuals became defendants in a purported class action suit. The initial complaint was filed in August 1985 by an MSU shareholder (purporting to represent a class that purchased MSU common stock), followed by four similar complaints filed by MSU shareholders in August and September 1985. The five actions were consolidated in the U.S. District Court for the Eastern District of Louisiana. The consolidated, amended and supplemental complaint alleged violations of the disclosure requirements of the Securities Exchange Act of 1934 and the Securities Act of 1933, common law fraud and common law negligent misrepresentation in connection with the financial condition of MSU and prayed for compensatory and punitive damages, legal costs and fees and other proper relief against MSU, various other Middle South System companies, including the Company, and certain officers (and former officers) and directors of MSU, the Company's outside auditors and certain underwriters of MSU common stock. In April 1986, MSU and the

other defendants, including the Company, filed a motion to dismiss or, in the alternative, a motion for summary judgment. On January 12, 1987, the District Court entered a judgment granting defendants' motions for summary judgment and dismissed the suit. On February 6, 1987, the plaintiffs in the consolidated action filed a Notice of Appeal in the United States Court of Appeals for the Fifth Circuit. Oral argument was held on November 5, 1987. The defendants have been vigorously opposing the appeal of the District Court's decision.

Unit Power Sales Agreement

On June 12, 1982, the Company and the System operating companies entered into a Unit Power Sales Agreement pursuant to which the Company agreed to sell all of the capacity and energy available to it from Grand Gulf 1 and Grand Gulf 2 to LP&L, MP&L and NOPSI in accordance with percentages specified therein, which conform with the percentages set forth in the Reallocation Agreement described below. As discussed under Note 8, "Rate and Regulatory Matters," the Unit Power Sales Agreement was, with certain modifications (including an allocation of capacity and energy from Grand Gulf 1 to AP&L), approved by the FERC in its June 13 Decision and ordered to become effective upon the initiation of service of Grand Gulf 1, which occurred on July 1, 1985. The FERC did not rule on the Grand Gulf 2 allocation and ordered the Company to remove the proposed Grand Gulf 2 percentage allocation from the Unit Power Sales Agreement. Also, as discussed under Note 8, "Rate and Regulatory Matters," the FERC's June 13 Decision was reversed, in part, and remanded for reconsideration. On November 30, 1987, the FERC issued an order which reaffirmed and reinstated the June 13 Decision, thus maintaining the previous allocation of Grand Gulf 1 capacity and energy among the System operating companies.

The Unit Power Sales Agreement, as currently in effect, specifies the rates to be charged to the System operating companies for their respective entitlements to receive capacity and energy from Grand Gulf 1. Such rates are computed monthly on the basis of the Company's total cost of service, which is based on the Company's operating expenses, depreciation and capital costs attributable to the unit for the month. These rates are paid in consideration for the respective entitlements of the System operating companies to receive such capacity and energy, and are payable irrespective of the quantity of energy delivered so long as the unit remains in commercial operation. Generally, operating expenses are computed by reference to amounts chargeable to the Company's operating expense accounts. Prior to July 1, 1987, capital costs were computed by allowing a 16% return on the Company's common equity funds and adding to such amount the effective interest and dividend cost to the Company during the billing period for its respective long-term debt and preferred stock. See Note 8, "Rate and Regulatory Matters," for information with respect to a settlement which, among other things, reduced the 16% return on the Company's common equity funds to 14% retroactive to July 1, 1987, and for information regarding the "equity reopener" issue.

Capital Funds, Availability and Reallocation Agreements

Under the Capital Funds Agreement, as supplemented, MSU has agreed to supply or cause to be supplied to the Company (1) such amounts of capital as may be required in order to maintain equity capital at an amount equal to at least 35% of the Company's total capitalization (excluding short-term debt) and (2) such amounts of capital as shall be required in order for the Company, (a) to construct, own and place in commercial operation the Grand Gulf Station, (b) to provide for pre-operating expenses and interest charges of the Company, (c) to permit the continuation of such commercial operation after commencement thereof and (d) to pay in full all indebtedness for borrowed money whether at maturity, on prepayment, on acceleration or otherwise. In addition, MSU has agreed to make cash capital contributions to enable the Company to make payments when due on its borrowings.

The System operating companies are severally obligated under the Availability Agreement in accordance with stated percentages (AP&L, 17.1%; LP&L, 26.9%; MP&L, 31.3%; NOPSI, 24.7%) to make payments or subordinated advances adequate to cover all of the operating expenses, including depreciation, of the Company. In November 1981, the System operating companies entered into a Reallocation Agreement which would have allocated the capacity, energy and the related costs available to the

(Note seven, continued)

Company from the Grand Gulf Station to LP&L, MP&L and NOPSI. These companies thus agreed to assume all the responsibilities and obligations of AP&L with respect to the Grand Gulf Station under the Availability Agreement and Power Purchase Advance Payment Agreement, with AP&L relinquishing its rights to capacity and energy from the Grand Gulf Station. Each of the System operating companies, including AP&L, however, would have remained primarily liable to the Company and its assignees for payments or advances under these agreements. AP&L was obligated to make its share of the payments or advances only if the other System operating companies were unable to meet their contractual obligations. However, the FERC's June 13 Decision allocating a portion of Grand Gulf 1 capacity and energy to AP&L supersedes the Reallocation Agreement insofar as it relates to Grand Gulf 1.

Amounts received by the Company under the Unit Power Sales Agreement have exceeded the amounts payable under the Availability Agreement and, consequently, no payments under the Availability Agreement have ever been required. Should there be a shortfall in any month as a result of the inability of any System operating company to make a payment under the Unit Power Sales Agreement (see "General" above), amounts received by the Company from any other sources (including financings, sales of property and the like) and available at that time would be credited toward the obligations owing under the Availability Agreement.

Nuclear Insurance

At December 31, 1987, the Price-Anderson Act (Act) limited the public liability of a licensee of a nuclear power plant to $720 million for a single nuclear incident. The Act in its present form provides that this limit will increase by $5 million for each additional operating license issued by the NRC. Insurance for this exposure is provided by private insurance and an indemnity agreement with the NRC. Every licensee of a nuclear power plant is obligated, in the event of a nuclear incident involving any commercial nuclear facility in the United States that results in damages in excess of the private insurance, to pay retrospective assessments of up to $5 million per incident for each licensed reactor it operates or up to a maximum per reactor owned of $10 million in any calendar year. The Company has a 90% undivided ownership interest in one licensed reactor.

Certain provisions of the Act expired in August 1987, and Congress is considering several proposals to amend and extend the Act. In this connection, the United States House of Representatives, on July 29, 1987, passed a bill which would, among other things, raise the public liability limit associated with any nuclear incident to approximately $7 billion. The bill further provides that each reactor licensee is responsible to share in this maximum liability (therefore, licensees are required to share in the assessment). Each reactor licensee would be liable for approximately $66 million per incident, provided that not more than $10 million would be required to be paid per incident per year. The United States Senate has under consideration a similar bill relating to the extension of the Act. Until a bill is adopted by both the Senate and House of Representatives and signed into law by the President, the provisions of the Act which expired August 1, 1987, will continue to apply to all currently licensed reactors (including the Grand Gulf Station). The Company is unable to predict what action Congress might ultimately take regarding the Act and what effect such action might have on the Company's potential liability.

The Company is a member-insured of Nuclear Electric Insurance Limited, an industry mutual insurer that, as of December 31, 1987, provided its members with insurance coverage of $775 million for property damage sustained by the insured in excess of $500 million caused by radioactive contamination or other specified damage. The Company has an additional $120 million of excess property and decontamination insurance with American Nuclear Insurers, a pool of private insurance carriers, thus giving the Company a total of $895 million excess property and decontamination insurance above the $500 million primary amount. The Company is also a member-insured under a primary property damage insurance program provided by Nuclear Mutual Limited, an industry mutual insurer, providing $500 million of coverage. As a member-insured with these industry mutual insurers, the Company is subject to assessments if losses exceed the accumulated funds available to the insurer. The Company's proposed maximum assessment for incidents occurring during a policy year

was approximately $37 million at December 31, 1987.

Effective October 5, 1987, the NRC amended its regulations to require nuclear power plant licensees to obtain property insurance coverage in the minimum amount of $1.06 billion. The regulations further provide that the proceeds of this insurance shall be used to first ensure that the licensed reactor is in a safe and stable condition and can be maintained in that condition so as to prevent any significant risk to the public health and safety. Within 30 days of stabilization, the licensee is required to prepare and submit to the NRC a cleanup plan for approval. The plan is required to identify all cleanup operations necessary to decontaminate the reactor sufficiently to permit the resumption of operations or to commence decommissioning. Any property insurance proceeds not already expended to place the reactor in a safe and stable condition must be used first to complete those decontamination operations that are ordered by the NRC. Property insurance proceeds subject to the decontamination priority must be payable to a separate trust established for the sole purpose of paying for costs incurred in decontaminating the reactor and removing radioactive debris. The NRC further requires that the decontamination priority and trust requirements set forth in the regulation be incorporated in on-site property damage insurance policies not later than October 4, 1988, and apply uniformly to all required on-site property damage insurance policies for nuclear power plants.

Effective as of January 1, 1988, the aggregate amount of property and decontamination expense insurance available for nuclear generating plants increased to $1.525 billion. With this increase, the coverage available above the amount required by the NRC to be set aside for reactor stabilization and cleanup is $465 million. However, the Company is unable to predict what effect the NRC's new regulation may have at the time when insurance proceeds would be made available to it or the trustee for the Company's bondholders.

Spent Nuclear Fuel

Under the terms of its nuclear fuel lease, the Company is responsible for the disposal of spent nuclear fuel. The Company has executed a contract with the U.S. Department of Energy (DOE) whereby the DOE will furnish disposal service for the Company's spent nuclear fuel at a cost of one mill per kilowatt-hour of net generation. The Company includes this one mill per kilowatt-hour cost as a component of its nuclear fuel expense.

8 RATE AND REGULATORY MATTERS

Unit Power Sales Agreement

On June 18, 1982, the Company tendered for filing with the FERC, as an initial rate schedule, the Unit Power Sales Agreement under which the Company would sell from its 90% share of Grand Gulf 1 and Grand Gulf 2 the following percentage allocations of capacity and energy: LP&L, 38.57% and 26.23%; MP&L, 31.63% and 43.97%; and NOPSI, 29.80% and 29.80%, respectively. The rates and charges after commercial operation commenced were to be based on the cost of service of each unit. Various parties, including the APSC, the LPSC, the MPSC, the Missouri Public Service Commission, and the Council, intervened in the proceedings, and some of these intervenors proposed, among other things, revised allocations of capacity and energy to the System operating companies, including an allocation of capacity and energy to AP&L.

(Note eight, continued)

On February 3, 1984, the ALJ in the Unit Power Sales Agreement proceeding issued his initial decision. Principally, the decision upheld, with certain modifications, the Company's request for the use of an automatic cost of service adjustment clause for Grand Gulf 1. The ALJ also affirmed a proposal made by the LPSC, an intervenor in the proceeding, to allocate capacity and energy from Grand Gulf 1 and the cost thereof as follows: AP&L, 36%; LP&L, 14%; MP&L, 33%; and NOPSI, 17%. On June 13, 1985, the FERC issued the June 13 Decision affirming the allocation of capacity and energy as proposed by the LPSC.

In the June 13 Decision, the FERC affirmed the ALJ's decision on all issues except for rate of return, depreciation, annual amount of decommissioning expense, amortization of limited-term electric plant and use of an income tax formula. The FERC held that the Company be granted a 16.00% return on common equity instead of 16.04% as proposed by the ALJ, that the units-of-production depreciation method be allowed for up to twelve months (later extended to eighteen months) with straight-line depreciation being required thereafter, and that the annual amount of decommissioning expense be set at $1,113,188 rather than $1,236,876 as proposed by the ALJ and be accumulated in an external fund. The FERC did not rule on the allocation of Grand Gulf 2, and ordered the Company to remove the proposed Grand Gulf 2 percentage allocation from the Unit Power Sales Agreement.

Various parties to these proceedings requested rehearings of the June 13 Decision. On September 26, 1985, the FERC issued an order denying all requests for rehearing of the June 13 Decision. Various parties, including AP&L and MP&L, filed appeals of these orders in the D.C. Circuit. On January 6, 1987, the D.C. Circuit affirmed the FERC's June 13 Decision. In its opinion, the D.C. Circuit held, among other things, that the allocation of Grand Gulf 1 capacity and costs was within the FERC's jurisdiction, that state commissions may not interfere with the FERC's plenary power to allocate Grand Gulf 1 capacity and costs, and that the FERC's June 13 Decision "was both rational and within the Commission's range of discretion to remedy unduly discriminatory rates." Petitions for rehearing and for a writ of certiorari to the United States Supreme Court were filed. On April 3, 1987, the D.C. Circuit ordered rehearing of two issues related to the allocation of the capacity and energy from Grand Gulf 1 raised in its January 6, 1987 decision. On June 24, 1987, the D.C. Circuit reversed, in part, the June 13 Decision and remanded the June 13 Decision (June 24 Remand) to the FERC for reconsideration of its decision to equalize the capacity costs of all System nuclear plants and for an explanation of the criteria used to determine what constituted "undue discrimination" under the Federal Power Act and why the June 13 Decision was not unduly discriminatory. In reversing, in part, the June 13 Decision, the D.C. Circuit did not change that part of its January 6, 1987, decision upholding the FERC's authority to review and modify the allocation of power from Grand Gulf 1. Subsequently, on July 24, 1987, the FERC issued an order which, among other things, stated that the rates currently in effect pursuant to the June 13 Decision would remain in effect during the FERC's reconsideration thereof. The Company filed a brief urging the FERC to find that the allocation of costs established in the June 13 Decision was just, reasonable and not unduly discriminatory.

As noted above, various parties filed petitions for certiorari with the United States Supreme Court seeking review of that portion of the D.C. Circuit's January 6, 1987, decision that affirmed the FERC's jurisdiction to allocate Grand Gulf 1 costs. Certain of these parties requested that the United States Supreme Court consider their challenges to FERC jurisdiction at the same time the Court considered MP&L's rate case appeal. On December 14, 1987, the United States Supreme Court denied, without comment, these petitions for certiorari, thereby leaving in place that part of the D.C. Circuit's January 6, 1987, decision upholding the FERC's jurisdiction to allocate Grand Gulf 1 costs.

On November 30, 1987, the FERC issued an order in response to the June 24 Remand whereby the FERC reaffirmed and reinstated the June 13 Decision, thus maintaining the previous allocation of Grand Gulf 1 capacity and energy among the System operating companies. In issuing the November 30 order, the FERC found that the allocation in the June 13 Decision was not unduly discriminatory. Requests for rehearing of the FERC's November 30 order

were filed by various parties (other than the System operating companies), and by order dated January 29, 1988, the FERC denied these requests. Petitions for review of the FERC's November 30, 1987, and January 29, 1988, orders have been filed with the D.C. Circuit by various parties.

It is not possible at this time to predict the ultimate outcome of this matter, including possible reallocation, if any, or the effect thereof upon the Company and the System operating companies, including possible refunds, if any. Any material modification of the allocation established by the June 13 Decision, as affirmed by the FERC's November 30 order, could give rise to additional litigation, disputes and challenges in the affected jurisdictions.

In addition, the System operating companies have initiated a study, currently scheduled to be completed in the near future, to determine whether a more equitable method of allocating future costs, including those relating to Grand Gulf 1, would be appropriate.

On September 17, 1986, the LPSC sent to the FERC for filing a complaint against the Company alleging that the 16.00% rate of return on common equity under the Unit Power Sales Agreement authorized by the June 13 Decision had become an unjust and unreasonable rate, and seeking the reduction thereof "to a just and reasonable level based on current conditions." Various parties intervened in this proceeding. On January 27, 1987, finding that the 16% return on common equity "may be excessive," the FERC denied the Company's motion to dismiss the complaint and ordered that hearings be held on the justness and reasonableness of such amount. On April 28, 1987, a settlement in principle was achieved which, among other things, reduced the rate of return on common equity in the Unit Power Sales Agreement from 16.00% to 14.00%, effective July 1, 1987. Such settlement was approved by the FERC on September 15, 1987.

The one issue that the settlement on the Company's return on equity did not resolve is whether the Unit Power Sales Agreement should be modified to include a clause which would permit an annual investigation of the return on equity in the Unit Power Sales Agreement with special refund procedures which are not currently provided for. This clause is referred to as the "equity reopener." Even if the FERC ultimately approves such a provision, under the settlement agreement discussed above, no change in the return on equity would go into effect any earlier than January 1, 1990. A prehearing conference was held on November 10, 1987. Oral argument was held on February 11, 1988. The matter is pending.

Rate Activity — System Operating Companies

All of the System operating companies have received retail rate increase authorizations approved by their respective regulatory authorities which they believe will be sufficient to enable them to meet their respective Grand Gulf 1 obligations to the Company if these rate structures remain in effect in their present form. However, final and favorable resolution of disputes over adequate retail rate relief for certain of the System operating companies has yet to be achieved, and some of the rate structures as initially implemented have changed, are in litigation, or have been or currently are the subject of prudence reviews or disallowances, as discussed below and in Note 7, "Commitments and Contingencies — General," and Note 7, "Commitments and Contingencies — Potential Debt Acceleration, Bankruptcy and Middle South System Viability."

Under their current rate structures, AP&L, LP&L and NOPSI are required to retain permanently and not recover certain costs, and AP&L, MP&L and NOPSI are required to phase-in certain costs associated with Grand Gulf 1. In connection with NOPSI's request for permanent retail electric rate relief, the Council, on October 17, 1985, initiated an investigation into all aspects of NOPSI's prudence regarding its involvement with Grand Gulf 1. On February 4, 1988, the Council adopted a resolution requiring NOPSI to write off and not to recover from its retail electric customers $135 million of its deferred Grand Gulf 1 costs, in addition to the $51.2 million of such costs that NOPSI had previously agreed to absorb in its March 1986 rate settlement. NOPSI is seeking relief in the courts from this finding by the Council of alleged imprudence, but, as a result of its inability to obtain injunctive relief that would stay the effectiveness of the Council's actions, NOPSI was required to record the write-off in 1987. If the Council's actions are not reversed, NOPSI may not be able to obtain the requisite funds to meet its ongoing obligations, including its obligations

(Note eight, continued)

to the Company, and could be rendered insolvent in a short period of time, possibly as early as the second quarter of 1988. See Note 7, "Commitments and Contingencies."

The MPSC's September 16, 1985, order, establishing a phase-in plan allowing recovery by MP&L of its payments to the Company with respect to costs associated with Grand Gulf 1, was appealed to the Mississippi Supreme Court by the Mississippi Attorney General and the Mississippi Legal Services Coalition. On February 25, 1987, the Mississippi Supreme Court rendered a decision reversing and remanding the rate case to the MPSC for further proceedings not inconsistent with the Court's opinion. The Mississippi Supreme Court found reversible error in the MPSC's September 16, 1985, order on the grounds that the MPSC (1) adopted retail rates to pay Grand Gulf 1 expenses without first determining that the expenses were prudently incurred, (2) failed to join MSU and the Company as parties to the rate proceeding, and (3) should not have allowed intervention in the proceeding by security holders of MSU. Subsequently, MP&L filed an appeal of the February 25 Decision with the United States Supreme Court and also filed an application asking that Court to stay the mandate of the February 25 Decision pending final disposition of the appeal. On June 1, 1987, such stay was granted. A condition of the stay was the posting of a good and sufficient bond in a manner and amount determined by the Mississippi Supreme Court. On June 10, 1987, the Mississippi Supreme Court issued an Order Setting Bond which provided that MP&L execute an unconditional corporate undertaking to "self insure" any refunds that may be required to be made with respect to Grand Gulf 1 costs previously collected by MP&L (approximately $279.8 million as of December 31, 1987). The order further stated that MP&L's undertaking be fully and unconditionally co-guaranteed (in the amount of approximately $206 million as of June 30, 1987) by the corporate undertakings of both MSU and the Company. In addition, the Company guaranteed and secured potential refunds of all Grand Gulf 1 costs collected by MP&L from and after June 1, 1987, to the date of final adjudication of MP&L's appeal to the United States Supreme Court by placing such amounts in a trust account each month for the benefit of MP&L's ratepayers. Through March 15, 1988, the Company expects that payments into the trust account under this requirement will approximate $138.5 million, and such payments are estimated to average approximately $14 million per month through June 1988, at which time it is expected that a decision shall have been rendered by the United States Supreme Court in MP&L's appeal. See Note 7, "Commitments and Contingencies — General."

In a separate proceeding, the MPSC initiated, among other things, an investigation of the prudence of MP&L's involvement in the Grand Gulf Station. On September 16, 1986, the MPSC issued an initial order establishing a docket for the stated purposes, among other things, of examining the prudence of the actions of MP&L and/or the Company relating to the construction and operation of the Grand Gulf Station and the appropriate regulatory treatment of the associated costs; obtaining FERC review of the Company's rate of return on common equity; obtaining FERC review and/or modification of various aspects of MP&L's Grand Gulf 1 expenses established by the FERC, including the allocation of Grand Gulf 1 costs; and performing a detailed audit of the books and records of the Company.

Furthermore, on February 3, 1987, the MPSC issued an order in this docket directing the Company and MP&L to show cause why their Certificate of Public Convenience and Necessity relating to the Grand Gulf Station should not be cancelled for the failure of the Company and MP&L to allow the MPSC to audit the books and records of the Company. The Company had objected to the MPSC auditing its books and records on jurisdictional and other grounds. On February 23, 1987, the Company and MP&L, in response to the Show Cause Order, filed with the MPSC separate Motions to Dismiss, Response and Reservation of Rights. These filings asked the MPSC to dismiss the show cause proceeding on jurisdictional, constitutional and other grounds. On March 3, 1987, the MPSC allowed SMEPA to intervene in the show cause proceeding. SMEPA also filed a Motion to Dismiss and Response to the Show Cause Order with the MPSC. The motions to dismiss filed by the Company, MP&L, and SMEPA have been overruled by the MPSC. On April 29, 1987, the Company filed a Complaint for Declaratory and Injunctive

Relief in a United States District Court seeking a temporary restraining order, a preliminary injunction, and a permanent injunction enjoining the MPSC from all further proceedings in the docket with respect to the Company. The District Court denied the Company's motion for temporary restraining order and permanent injunction. The Company, in light of the District Court's decision and in order to avoid irreparable harm that could result from the threatened cancellation of the Grand Gulf Certificate, agreed to cooperate with the MPSC staff in an audit of the books and records of the Company relating to FERC-approved Grand Gulf 1 rates. The Company has stated that it intends to pursue its request for declaratory and permanent injunctive relief in the federal court action. This action is pending. See Note 7, "Commitments and Contingencies — Potential Debt Acceleration, Bankruptcy and Middle South System Viability."

The MPSC on September 26, 1983, issued a Citation to Show Cause to MP&L and the Company to show why they should not be ordered to adhere to representations allegedly relied upon by the MPSC in determining the need and economic justification for additional generating capacity in the form of the Grand Gulf Station. On January 5, 1984, the MPSC issued an order in which it (1) limited the proceeding to relate solely to Grand Gulf 2 and (2) ordered the Company and MP&L to show cause for the continued construction and need for Grand Gulf 2. On September 18, 1985, the MPSC issued an Order Directing Suspension of Construction of Grand Gulf 2, which directed the Company and MP&L to suspend construction of Grand Gulf 2 as of the date of the order and to formally report to the MPSC before the end of the year regarding their future plans for the unit. As an addendum to the order, the MPSC advised MP&L and the Company that it was the MPSC's position at that time that any potential plan for recovery by MP&L of "sunk costs" in Grand Gulf 2 through retail rates was unjustifiable. Since September 1985, the Company has continued suspension of construction on Grand Gulf 2 and has limited expenditures on the unit to only those activities which are absolutely necessary for demobilization and suspension. On December 5, 1986, the Company's Board of Directors (with the MSU Board of Directors concurring) adopted the recommendation of a special group of Middle South System officials and outside consultants that suspension of construction activities be continued and that a further decision be made by 1990 on the future status of Grand Gulf 2, in light of alternatives available at that time.

9 NUCLEAR FUEL LEASES

At December 31, 1987, the Company had a nuclear fuel lease permitting a maximum of $175 million in nuclear fuel under lease. The maximum amount of the lease was decreased from $175 million to $165 million upon its renewal in February 1988. Lease payments, based upon nuclear fuel use, are treated as a cost of fuel. Lease expense charged to operations for the year ended December 31, 1987, 1986, and 1985 was $58.8 million, $41.0 million, and $31.5 million, respectively. The unrecovered cost base of the lease at December 31, 1987 and 1986 was $166 million and $147 million, respectively. This lease, which was to

(Note nine, continued)

continue through 2029, is likely to terminate in August 1988 if the credit line supporting the nuclear fuel lease terminates at that time, as scheduled.

In February 1988, an agreement was entered into by the Company for the sale and leaseback of up to $50 million of the unleased nuclear fuel on its balance sheet. The lease extends for one year with monthly extensions thereafter until notice is given by either party thereto.

The Company currently assumes that either both credit lines will be extended or that alternative credit lines will be arranged. To the extent, however, that this does not occur, additional financing requirements of up to $215 million could result.

Effective in 1987, the Company began complying with the provisions of SFAS No. 13 and SFAS No. 71 with respect to accounting for lease obligations.

10 POST-RETIREMENT BENEFITS

The Company participates in an MSU System postretirement plan covering substantially all of its employees. The pension plan is noncontributory and provides pension benefits that are based on the employees' credited service and average compensation, generally during the last five years before retirement. The Company's policy is to fund pension costs in accordance with contribution guidelines established by the Employee Retirement Income Security Act of 1974.

The pension plan is administered by a trustee who is responsible for pension payments to retirees. Various investment managers have responsibility for management of the plan's assets. In addition, an independent actuary performs the necessary actuarial valuations for the Company's plan.

Prior to January 1, 1987, the Company did not directly employ any personnel and substantially all of the Company's employees were covered under a postretirement benefit plan administered by MP&L. In return, the Company reimbursed MP&L for the cost of this plan applicable to its employees. Effective January 1, 1987, approximately 950 MP&L employees transferred to the Company. The related pension liabilities and estimated assets as of that date of $44.4 million and $15.7 million, respectively, were transferred, subject to a final true-up of estimated assets, to a postretirement benefit plan administered by MSU. These liabilities and assets will be transferred to a separate Company plan when established.

Total pension cost (income) of the Company for 1987, 1986, and 1985 was approximately $(1.8) million, $1.7 million, and $1.7 million, respectively. Total pension cost for 1987 includes a $1.2 million reimbursement from MP&L for overfunding in 1986. Pension cost decreased in 1987 primarily as a result of the adoption of the provisions of SFAS No. 87, Employers' Accounting for Pensions, used to determine net pension cost for the year.

The components of the Company's total 1987 pension cost (income), including amounts capitalized, were as follows:

		(In Thousands)
Service cost — benefits earned during the period	$	994
Interest cost on projected benefit obligation		355
Actual return on plan assets		2,115
Net amortization and deferral		(4,045)
Net pension income	$	(581)

The assets of the plan consist primarily of common and preferred stocks, fixed income securities and insurance contracts.

The funded status of the Company's pension plan at December 31, 1987, was as follows:

		(In Thousands)
Actuarial present value of accumulated pension plan benefits:		
Vested	$	633
Nonvested		1,523
Accumulated benefit obligation	$	2,156
Projected benefit obligation	$	4,788
Plan assets at fair value		13,585
Plan assets in excess of projected benefit obligation		8,797
Unrecognized transition asset		(10,660)
Unrecognized net loss		2,444
Accrued pension asset	$	581

The weighted average discount rate and rate of increase in future compensation used in determining the actuarial present value of the above projected benefit obligation were 9.0% and 5.6%, respectively. The expected long-term rate of return on plan assets was 8.5%. Transition assets are being amortized over the average remaining service period of active participants.

The Company also provides certain health care and life insurance benefits. Substantially all employees may become eligible for these benefits if they reach retirement age while still working for the Company. These benefits and similar benefits for active employees are provided through payments of premiums to insurance companies, and the Company recognizes the cost of providing these benefits by expensing the amounts as incurred. While the Company had no retirees as of December 31, 1987, the cost of providing these benefits for future retirees may not be separable from the cost of providing benefits for active employees. The cost of providing these benefits for 1987, 1986, and 1985 was $1,604,000, $945,000, and $671,000, respectively.

11 TRANSACTIONS WITH AFFILIATES

The Company sells all of the capacity and energy from its 90% share of Grand Gulf 1 to the System operating companies under rate schedules approved by the FERC in its June 13 Decision regarding the Unit Power Sales Agreement. Accordingly, all of the Company's operating revenues consist of billings to the System operating companies.

Pursuant to a service agreement, MP&L provided technical and advisory services to the Company for the design, construction, maintenance and operation of the Grand Gulf Station. See Note 1, "Summary of Significant Accounting Policies." In return, the Company paid MP&L the actual cost of rendering these services and granted to MP&L the power and authority to act on the Company's behalf as agent, until December 20, 1986, when the Company assumed the responsibilities previously assigned to MP&L. In addition, pursuant to another service agreement, the Company receives technical and advisory services from MSU System Services, Inc. Operating expenses included charges from MP&L and MSU System Services, Inc. for technical and advisory services totaling $11.1 million in 1987, $45.8 million in 1986, and $40.7 million in 1985.

In addition, certain materials and services required for fabrication of nuclear fuel are acquired and financed by SFI and then sold to the Company, as needed. Charges for these materials and services amounted to approximately $104.9 million in 1987 and $0.3 million in 1986. No purchases were made in 1985.

12 QUARTERLY RESULTS (UNAUDITED)

Results for the four quarters of 1987 and 1986 were as follows:

Quarter Ended	Operating Revenues	Operating Income	Net Income
		(In Thousands)	
1987:			
March	$ 242,564	$ 116,532	$ 52,526
June	$ 248,537	$ 115,773	$ 52,881
September	$ 224,519	$ 105,910	$ 44,431
December	$ 246,929	$ 108,058	$ 48,963
1986:			
March	$ 248,997	$ 121,719	$ 46,104
June	$ 251,523	$ 117,897	$ 46,490
September	$ 239,563	$ 113,776	$ 47,958
December	$ 219,654	$ 114,359	$ 48,583

SELECTED FINANCIAL DATA — FIVE-YEAR COMPARISON

Years Ended December 31	1987	1986	1985	1984	1983
			(In Thousands)		
Operating Revenues	$ 962,549	$ 959,737	$ 524,012	—	—
Allowance for Funds Used During Construction (AFDC)	$ (4,616)	$ (4,591)	$ 224,360	$ 376,477	$ 293,179
Net Income	$ 198,801	$ 189,135	$ 218,067	$ 188,425	$ 151,581
Construction Expenditures (includes AFDC)	$ 34,597	$ 40,782	$ 335,656	$ 581,184	$ 572,448
Total Assets	$ 5,422,329	$ 4,950,118	$ 4,947,418	$ 4,780,456	$ 3,747,945

AUDITORS' OPINION

System Energy Resources, Inc.:

We have examined the balance sheets of System Energy Resources, Inc. (formerly Middle South Energy, Inc.) as of December 31, 1987 and 1986 and the related statements of income, of retained earnings and of cash flows for each of the three years in the 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.

As discussed in Notes 7 and 8 of Notes to Financial Statements, there are uncertainties associated with the Grand Gulf Nuclear Station. These uncertainties involve: the recovery of the investment in Grand Gulf 2, a suspended construction project; the resolution of rate and regulatory matters involving the possible adjustment of certain existing rate structures (which are being contested or are subject to prudence investigations) implemented by the Middle South System operating companies to recover their Grand Gulf 1 related costs; the potential acceleration of certain indebtedness of the Company as a result of the possible failure of certain of the Middle South System operating companies to maintain adequate rates to recover their Grand Gulf 1 related costs; and an audit report issued by the Staff of the Federal Energy Regulatory Commission on June 18, 1987 which states, among other things, that the Grand Gulf Station's allowance for funds used during construction is overstated. The Company is unable to predict the ultimate outcome of these matters, and no provision for any losses that may result from their resolution has been made in the financial statements.

In our opinion, subject to the effects on the financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainties referred to in the second paragraph been known, the above-mentioned financial statements present fairly the financial position of the Company at December 31, 1987 and 1986 and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1987, in conformity with generally accepted accounting principles applied on a consistent basis.

Deloitte Haskins & Sells

New Orleans, Louisiana
February 19, 1988

Directors and Executive Officers

Directors

EDWIN LUPBERGER
Chairman of the Board of the Company
Chairman of the Board and President of Middle South Utilities, Inc.

WILLIAM CAVANAUGH, III
President and Chief Executive Officer of the Company
Senior Vice President, System Executive — Nuclear of Middle South Utilities, Inc. and MSU System Services, Inc.

JAMES M. CAIN
President and Chief Executive Officer of Louisiana Power & Light Company, President of New Orleans Public Service Inc.

DONALD C. LUTKEN
Chairman of the Board and President of Mississippi Power & Light Company

JERRY L. MAULDEN
President and Chief Executive Officer of Arkansas Power & Light Company

JOSEPH M. HENDRIE
Nuclear Engineering Consultant, Bellport, NY, Senior Scientist — Research and Development, Brookhaven National Laboratory

Executive Officers

EDWIN LUPBERGER
Chairman of the Board

WILLIAM CAVANAUGH, III
President and Chief Executive Officer

GLENN E. HARDER
Vice President — Accounting and Treasurer

RICHARD J. LANDY
Vice President — Human Resources and Administration

OLIVER D. KINGSLEY, JR.
Vice President — Nuclear Operations

TED H. CLONINGER
Vice President — Nuclear Engineering and Support

DAN E. STAPP
Secretary

The Company's 1987 Annual Report to the Securities and Exchange Commission on Form 10-K (including financial statement schedules) is available to any interested parties without charge. Interested parties can obtain a copy by writing to:

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