HOUSTON INDUSTRIES INCORPORATED

1987 Annual Report

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Prevailing winds. Shifting tides. Changes in direction on the road to the future. Opportunities. Threats. Undeniable. Unstoppable. Houston Industries, like all businesses, is impacted by trends: Global financial trends. Local economic trends. Industry directions. We're continuing a long history of success by understanding, adapting to and, where possible, shaping the changes that are affecting our future.

Houston Industries Incorporated is the parent company of seven subsidiaries:
Houston Lighting & Power Company. *HL&P is the nation's eighth largest electric utility in terms of kilowatt-hour sales, serving a 5,000 square-mile area which includes Houston, the nation's fourth largest city.* Primary Fuels, Inc. *PFI is an oil and gas exploration and production company with domestic production and reserves located in the continental U.S. and in the Gulf of Mexico, as well as international production in several countries.* Utility Fuels, Inc. *UFI is a full-service coal supply company involved in the acquisition, transportation, handling, and administration of coal and lignite for electric generating plants.* KBLCOM Incorporated. *KBLCOM is involved in the ownership and operation of cable television systems. It holds a 50 percent interest in a multi-state cable television joint venture called Paragon Communications, which serves over 650,000 customers.* Innovative Controls, Inc. *ICI develops and markets high-intensity discharge lights driven by electronic ballasts.* Houston Industries Finance, Inc. *HIF purchases accounts receivable of HL&P.* Development Ventures, Inc. *DVI is a venture capital organization which invests in established funds and provides start-up financing for small businesses.*

FINANCIAL HIGHLIGHTS

	1987	1986
Operating Revenues (000)	**$3,628,213**	$3,535,968
Operating Expenses (000)	**$2,890,745**	$2,809,387
Net Income (000)	**$434,958**	$424,935
Earnings Per Share	**$3.74**	$3.81
Dividends Per Share	**$2.86**	$2.76
Average Number of Shares Outstanding (000)	**116,322**	111,593
Return on Average Common Equity	**13.6%**	14.5%
Fixed Charge Coverage Ratio	**2.86**	2.76
Price/Earnings Ratio	**8.0**	9.1
Book Value Per Share (year-end)	**$28.33**	$27.19
Market Price (year-end closing)	**$30.00**	$34.75
Market To Book Value	**106%**	128%
Total Return (Dividends & Price Appreciation)	**−5%**	34%
Number of Common Stockholders	**78,880**	81,914

TABLE OF CONTENTS

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TABLE OF CONTENTS

TO OUR SHAREHOLDERS

Nineteen-eighty-seven was a year of hard work, significant successes and building for the future for both Houston Industries Incorporated and our home city.

- Houston Industries achieved earnings of $435.0 million, up from $424.9 million in 1986. Earnings per share were $3.74 in 1987, compared to $3.81 the previous year.
- Houston Lighting & Power Company, our major subsidiary, completed construction of Unit 1 at the South Texas Project and received a license for fuel loading and low-power operation.
- The Houston economy, which has been feeling the effects of depressed conditions in the energy sector, began showing early but convincing signs of economic recovery.

Earnings Withstand Short-Term Impacts

Houston Industries achieved solid financial results despite factors which continued to impact Houston Lighting & Power (HL&P) and Primary Fuels, Inc., our oil and gas subsidiary.

HL&P felt the effects of a soft local economy and increased expenses due, primarily, to the cost of operating a new generating unit, which is not fully reflected in electric rates. HL&P's earnings were $408.6 million, or $3.51 per share, compared to $434.9 million or $3.90 per share in 1986.

Primary Fuels, while still affected by unstable oil and gas prices, recorded significantly improved results during 1987, with a profit of $4.5 million, compared to a $27.7 million loss in 1986.

Earnings for Utility Fuels, Inc., our coal supply subsidiary, increased to $24.2 million in 1987, compared to $21.9 million the previous year.

HL&P will file a rate increase request during the first half of 1988, primarily for recovery of costs associated with building and operating two new generating units. An equitable decision by the Public Utility Commission of Texas could improve the financial outlook for HL&P in 1989.

Nuclear Plant Moves Toward Operation

The past year has been one of major triumphs and a few disappointments for the South Texas Project (STP). In August 1987, the Nuclear Regulatory Commission issued a license for fuel loading and low-power operation of Unit 1. The first nuclear reaction took place March 8, 1988.

We expect to put the unit in commercial operation in the summer of 1988.

After five years of successfully managing an aggressive budget and schedule for STP, the commercial operation date for Unit 1 slipped somewhat from our target date of December 1987. In addition, the estimated completed cost of the plant has increased by approximately 5.5 percent, compared to the budget established in August 1982 when about two thirds of the construction work still lay ahead.

Unit 2 was 86.2 percent complete at the end of 1987, on schedule for fuel loading in December 1988 and commercial operation the following June.

Austin Settlement Sought

Following months of intense negotiations with the City of Austin, HL&P reached an agreement to acquire Austin's share of STP and to resolve a long-standing legal dispute between the two parties. However, the agreement is subject to a number of events and conditions, including approval by state regulators and the Nuclear Regulatory Commission.

If the agreement can be concluded, HL&P will acquire Austin's 16 percent share of STP in exchange for an equal amount of capacity at HL&P's Limestone lignite plant. In addition, HL&P will make a cash payment for purchase of nuclear fuel owned by Austin, reimbursement of construction expenses incurred by Austin during the later stages of negotiations, legal fees, and settlement of an unrelated purchased power contract.

I am convinced that the settlement is in the best interests of both parties. We are committed to working toward resolution of the remaining conditions.

In January 1988, HL&P filed legal petitions designed to avert additional litigation related to STP. The petitions ask the courts to define certain rights and obligations of HL&P in relation to the other STP owners. In response to HL&P's petitions, the other owners have sought arbitration of the disputes.

HI Seeks Growth Through Diversification

Houston Industries is looking ahead to a period of declining capital requirements, improved cash flows, and modest growth for its principal subsidiary, HL&P. We are, therefore, pursuing a diversification program seeking business opportunities which offer the potential for additional earnings growth in the future.

However, our diversification program is in its early stages, and we are proceeding cautiously. HL&P will remain our core business for the foreseeable future, and continuing our record of success within the electric utility industry is a top priority.

HL&P Launches Marketing Effort

Success within the electric utility industry requires looking ahead and adapting to the fundamental changes that are occurring. These include increasing competition, both from the natural gas industry and from cogenerators. That means HL&P must become much more competitive.

In addition to ongoing cost control efforts, which are helping keep electric rates down, we are launching a greatly expanded marketing effort in 1988.

HL&P devoted seven months during 1987 to a detailed study of the marketplace for electricity. The result was a blueprint, by market segment, for a comprehensive program to increase the use of electricity where beneficial to both customers and shareholders.

The increased sales expected to result from these marketing programs will boost revenues and support our goal of holding down electricity costs by allowing fixed costs to be spread over a greater number of kilowatt-hours sold.

City Builds for the Future

Just as HL&P is faced with competition for electricity sales, the Houston area is faced with competition in attracting new businesses that will enhance the economy of the area. Success in that arena requires a willingness to invest in the future.

In Houston, we are continuing to build the infrastructure which will make our region an increasingly attractive place for new business to locate and prosper. A case in point was voter approval, in early 1988, to proceed with a metro mobility construction program, which has set the course for transportation improvements in the Houston area through the year 2000.

The plan, which includes improvements to existing transportation systems and construction of a light rail system, will enhance the appeal of our area and contribute to the success of our economic development efforts.

For Houston Industries and the Houston-Gulf Coast, 1987 was a year of progress. The forward-looking people in our communities, and the dedicated employees within our Company, are the driving forces behind that progress.

I also would like to commend our Directors, who are called on to participate more than the directors of any company with which I am familiar. They were asked to attend an average of 33 meetings each during 1987, and their response was exemplary. Attendance at meetings of the full Board and of the various committees averaged 92 percent.

We owe a special debt of gratitude for the contributions of three Directors who are retiring this year. Searcy Bracewell has been a Director for 11 years, Joe Wessendorff for 9 years and I.A. Naman for 5 years. Their dedicated service is appreciated and their wise counsel will be missed.

Our continued success also depends on your support. We sincerely appreciate your interest in Houston Industries and remain committed to providing you with attractive, stable dividends while pursuing opportunities for long-term growth.

Don D. Jordan

Don D. Jordan
President and
Chief Executive Officer

Houston, Texas
March 15, 1988

Maintaining an even keel in stormy waters

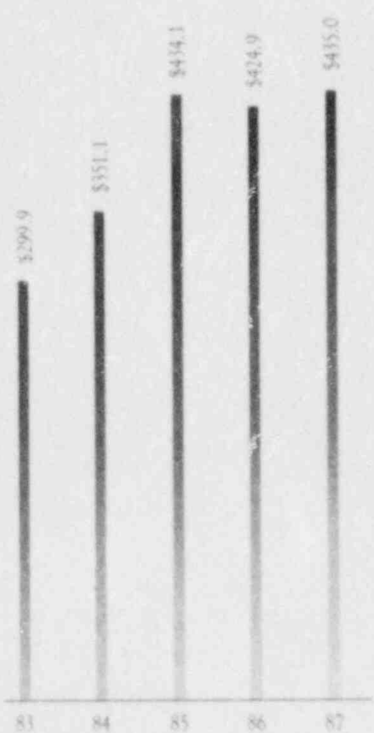
Reliable utilities. ♦ They're known for service customers count on. Earnings investors bank on. Consistent quarterly dividends and attractive yields. Stable stock prices. Moderate risk, moderate gains. Most of the time. ♦ In the mid-1980s, utility stocks registered robust price gains: Riding the bull on Wall Street. Gaining momentum as interest rates tumbled and investors bid up the prices of high-yielding shares. ♦ Then, the ups and downs of '87: For utilities, a peak in January. And a retreat, as interest rates inched upward. Investors turned their attention to industries where the bull charged on. ♦ Until October: Black Monday. A frightening plunge. Wall Street's wild ride carried Dow Industrials down 23 percent for the month. S & P 500, off 22 percent. ♦ For utilities: Smoother sailing. Smaller price swings during the year. And, in the aftermath of October, more investors seeking shelter in safe, stable, high-yield investments. ♦ Entering '88: Two pluses for utility stocks. Easing interest rates. Sound industry fundamentals: Stable earnings. Growing financial strength as a decade of capital expansion ends. Capital requirements down. Long-term debt shrinking. Cash flows expanding. ♦ Slow growth, low growth from utility operations. Upside potential from diversification. ♦ Diversified utilities are investing available cash, pursuing new sources of growth. Seeking a healthy balance: Regulated and unregulated businesses. Stability and growth. Providing economical electric service while maximizing shareholder value.

T R E N D S

Utility stocks had their ups and downs during [illegible] by [illegible] other indu[illegible] during recent market volatility.

Houston Industries is committed to maintaining the stable investment position of its strong utility base, while pursuing additional growth through a modest diversification program.

NET INCOME *in millions*



Consolidated net income for 1987 was $435.0 million, up $10.1 million from 1986 earnings.

Earnings

Houston Industries achieved earnings of $435.0 million during 1987, up from the $424.9 million earned during 1986. However, earnings per share decreased to $3.74 in 1987, compared to $3.81 the previous year, on a 4.2 percent increase in the weighted average number of shares outstanding. Return on average common equity was 13.6 percent, compared to 14.5 percent in 1986.

Houston Lighting & Power Company, HI's principal subsidiary, recorded earnings of $408.6 million, or $3.51 per share, in 1987, compared to $434.9 million, or $3.90 per share, the previous year.

Allowance for Funds Used During Construction (AFUDC), or non-cash earnings that represent the carrying costs associated with construction expenditures, accounted for 52 percent of HL&P's earnings in both 1987 and 1986.

Outlook

Operating costs for new generating units, which will not be fully reflected in electric rates until HL&P's next rate order, will again create downward pressure on earnings in 1988, particularly after Unit 1 at the South Texas Project (STP) is in service.

HL&P plans to file a rate increase request during the first half of 1988, primarily for costs associated with Limestone Unit 2 and STP Unit 1. Action by the Public Utility Commission of Texas (PUC) on the rate request could improve the financial outlook in 1989.

To relieve pressure on earnings in the interim, HL&P has asked the PUC to authorize deferred accounting for Limestone Unit 2 and STP Unit 1. This would allow HL&P to capitalize operating costs and carrying costs incurred from the in-service date until these units are included in electric rates.

With only one generating unit still under construction, HL&P will be entering a period of improved cash flow and substantially lower capital requirements. Assuming that sufficient rate relief is granted, the quality of earnings also should improve as non-cash earnings would account for a decreasing portion of total earnings.

Stock Performance, Dividends

After reaching a 20-year high in January 1987, Houston Industries common stock, like many other issues, took a disappointing turn later in the year.

HI closed at $30 per share on December 31, 1987, down 13.7 percent from the previous year-end price of $34.75. This was slightly better than the Dow Jones Utility Index, which declined 15 percent during the year.

While stock prices have lost some ground, HI continues to provide shareholders with an attractive, stable source of income. The dividend yield averaged 8.6 percent during 1987.

Effective with the June 1987 payment, the quarterly dividend was increased from 70 to 72 cents per share, for an annual rate of $2.88. This marked the 18th increase in the past 18 years, and the 66th consecutive year that the Company has paid regular quarterly dividends on its common stock.

At prices prevalent during the first quarter of 1988, current dividends were providing a yield of over 9 percent.

Bond Refinancings

Houston Industries continues to utilize innovative financing techniques to meet the individual needs of its various subsidiaries.

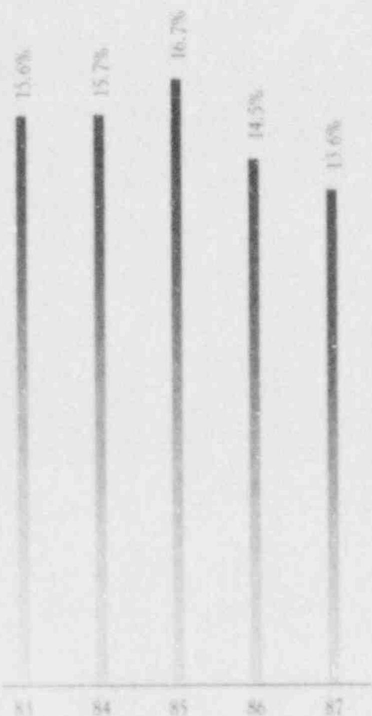
For example, the Company has been aggressive in refinancing high-coupon HL&P bonds in support of company-wide efforts to hold down expenses. At the end of 1987, HL&P's embedded cost of long-term debt was 8.32 percent, down from 8.74 percent at the end of the previous year.

Contributing to this reduction was the retirement of more than $390 million of high-coupon first mortgage bonds through exchange offers. Holders of the high-coupon bonds received new 9 percent bonds and a cash premium.

EARNINGS PER SHARE

Consolidated earnings per share were $3.74 in 1987, down $.07 a share from 1986, on a 4.2 percent increase in the weighted average number of shares outstanding.

RETURN ON AVERAGE
COMMON EQUITY



Return on average common equity was 13.6 percent in 1987, compared to 14.5 percent during 1986.

The exchange offers, announced in February 1987, were coupled with an announcement that up to $145 million of the outstanding bonds would be subject to redemption, at par, under the annual replacement fund provisions of HL&P's mortgage and deed of trust.

The goals in structuring the exchange offers were to achieve a high level of participation, minimize the cash premiums paid, and avoid conventional investment banking fees.

The exchange offers, together with the subsequent replacement fund call of $140 million principal amount of first mortgage bonds, reduced HL&P's annual interest expense by approximately $14 million. HL&P also saved about $45 million in cash premiums, tender fees, and underwriting costs.

New Financings

HL&P raised $99 million of new capital in June 1987 through the sale of 1 million shares of preferred stock carrying an $8.50 annual dividend. Unlike HL&P's other preferred series, the new preferred is subject to a mandatory sinking fund beginning in the 6th year, and has an average life of 8 years.

In January 1988, HL&P issued $400 million aggregate principal amount of 9⅛ percent first mortgage bonds in a private placement. Approximately equal principal amounts of this issue will mature in 3, 4, and 5 years. Proceeds were used to pay expenditures related to HL&P's construction program, including repayment of construction-related, short-term debt, and to call the remaining $48.5 million principal amount of 13⅞ percent series first mortgage bonds.

Houston Industries Finance, Inc. (HIF) established a $300 million bank credit facility in July 1987 to finance the purchase of HL&P accounts receivable.

Later in the year, the finance subsidiary implemented its own commercial paper program. The commercial paper received a rating of Duff 1+ from Duff & Phelps and a rating of P-1 from

Moody's. These are the highest short-term ratings given by the agencies.

HIF is now using the commercial paper for short-term borrowing, with the bank credit facility serving principally as a backup.

Paragon Communications, a cable television operating company in which HI has a 50 percent interest, finalized a $430 million bank credit facility during 1987. Proceeds from borrowings under the facility, which is non-recourse to HI, were used to permanently finance the acquisition of cable television properties distributed from the Group W purchase.

Paragon's revolving credit facility provides financing flexibility through a letter of credit feature, which can be used to support the issuance of Paragon debt securities.

Stock Sales

HI issued 3.5 million shares of common stock during 1987 through its continuous offering program, its dividend reinvestment plan, and certain employee benefit plans.

Of this number, 1,863,000 shares were sold through the continuous offering program. Net proceeds were approximately $70.3 million, or an average of $37.73 per share.

Capital Requirements

Capital requirements, while still substantial, are continuing to decline as HL&P's power plant construction program winds down. Projected capital requirements for 1988, 1989, and 1990, exclusive of AFUDC and maturities of long-term debt, are as follows:

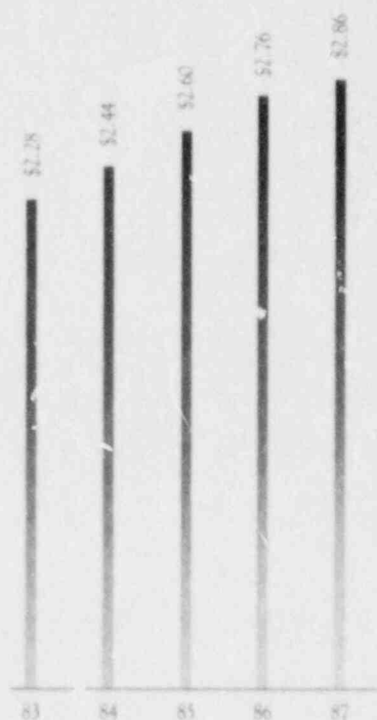
Capital Requirements

(Millions of Dollars)	1988	1989	1990
Houston Lighting & Power Company*	$ 495	$ 444	$ 368
Utility Fuels, Inc.	$ 57	$ 46	$ 24
Primary Fuels, Inc.	$ 57	$ **	$ **
TOTAL	$ 609	$ 490	$ 392

*Houston Lighting & Power capital requirements do not reflect the possible acquisition of an additional 16 percent share of the South Texas Project.

**Primary Fuels' expenditures for oil and gas exploration subsequent to 1988 are dependent on results of its 1988 exploration and development program, and factors affecting the oil and gas industry.

CASH DIVIDENDS DECLARED PER COMMON SHARE



The quarterly dividend was raised from 70 to 72 cents per share during 1987, effective with the June dividend payment.

Cultivating a bountiful future

In its heyday, Houston had it all. Or so it seemed. ♦ *It was a big time, boom town, in the national spotlight. Help wanted signs, construction permits, and U-haul trailers with Michigan plates. All were signs of the times: Good times. The days of $35-a-barrel oil. On the way to $50, some believed.* ♦ *Build. Borrow. Build some more. Working to keep ahead of growth. Driven by the oil price surge.* ♦ *Suddenly: Oversupply, underdemand. Oil prices plummeted, below $10 a barrel in '86. Drilling activity dropped. Sales of equipment and materials followed.* ♦ *Next the plant closings. And the layoffs. Then, the ripple effect: Construction. Banking. Entertainment, restaurants, and retail. Slowdown. Crankdown. Office glut, foreclosures and U-hauls out of town.* ♦ *Finally, a turning point. Houston found the bottom, and started turning up.* ♦ *In 1987: The last stubborn symptoms of economic ills. The first vital signs of recovery: Unemployment falling. Office space filling. Petrochemicals rebounding. Air travel rising. The Port of Houston building steam. And the seeds of renewed growth from a healthy mix of industries.* ♦ *Aerospace: $2 billion in new NASA contracts. Medicine: $1.5 billion in new construction. Conventions and [illegible]: A new $100 million convention center.* ♦ *Meanwhile, energy is starting a bumpy comeback: Oil prices up and down. Gas strengthening. Exploration and production budgets up 12 to 20 percent for 1988.* ♦ *The future: Gradual, stable growth. Outpacing the national average over the next decade. Increasing economic diversity as Houston rebuilds on old strengths and expands its horizons. Cultivating a bountiful future after the drought.*

TRENDS

The Houston economy has suffered from layoffs and setbacks in the energy industry, but is now [illegible]

HL&P is active in economic development activities to further strengthen and diversify the area economy.

HL&P Sales Improve

Just as the Houston economy turned an important corner during 1987 and began showing signs of renewed growth, Houston Lighting & Power Company also reversed recent trends, with the first sales increase in three years. Sales for 1987 were up by 3.5 percent compared to 1986, primarily as the result of increases in off-system sales and interruptible sales to industrial customers.

Interruptible sales are sales to large customers who are able to accept the risk of curtailments during periods of peak demand for electricity in return for lower rates. Off-system sales are made to other utilities, frequently as economy energy transactions, when HL&P can provide energy at a cost lower than that of their other alternatives.

Increasing off-system sales is an HL&P strategy for utilizing available capacity. As a result of stepped up marketing efforts, revenue from off-system sales jumped to $32.2 million in 1987, up from $16.9 in 1986.

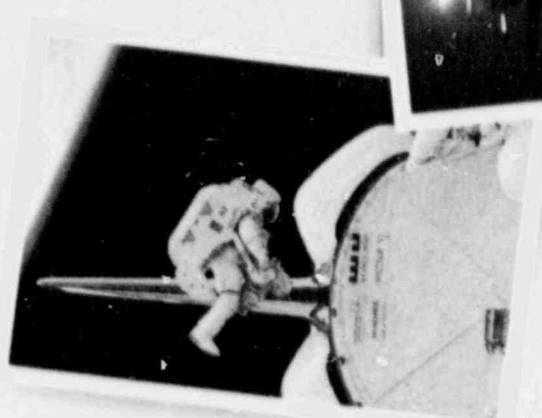
Industrial sales increased by 4.8 percent during 1987, fueled in part by a rebound in the petrochemical industry. Residential sales, the number of residential customers served, and their average use showed little change in 1987. Commercial sales declined 2.2 percent during the year.

Peak demand for electricity in 1987 was 10,302 megawatts, excluding interruptible demand of 1,016 megawatts. This is down from 10,556 megawatts in 1986. However, when interruptible sales are included, the peak demand actually served hit a new high of 11,318 megawatts in 1987.

Growth in peak demand for electricity is expected to reflect the pattern of economic recovery. The compound annual growth rate in peak demand over the decade from 1988–1998 is projected at 1.1 percent.

In addition to the Houston economy, HL&P's future electricity sales will be influenced by fundamental changes within the electric utility industry. HL&P's strategies stress cost control, excellent customer service, and expanding the markets for its product.

Nearly $1.5 billion in construction was underway, approved, or completed during 1987 at The Texas Medical Center in Houston.



A $2 billion NASA contract awarded to McDonnell Douglas during 1987 will benefit the Houston economy.

Shipments through the Port of Houston rose briskly during 1987, running almost ten percent above 1986 totals.

Shaping the bid for a more competitive future

The electric company. The only one in town. ♦ With good reason. Regulated utilities have served the public well. Bigger plants and better technology kept rates low and stable. For almost a century. ♦ Then came the seventies, the decade of inflation: The energy crunch sent fuel prices soaring. Interest rates rose. Construction costs climbed. ♦ Electricity bills followed suit, and demand dwindled. Meanwhile, supply expanded. In the name of conservation. In the form of cogeneration. ♦ Cogeneration is: Production of electricity and another form of energy from the same fuel. An old technology. Revitalized by tax breaks. Nurtured by federal policies requiring utilities to buy cogenerated kilowatts. New source of profit for industrial cogenerators. New source of competition for utilities. ♦ New rules. Different rules for different players: Utilities vs. cogenerators. Regulated vs. unregulated. Utilities in business to serve, over the long term. Cogenerators sell at will, as long as profits are high. Utilities must buy, cogenerators not required to supply. Surplus today, shortage tomorrow? ♦ Then the eighties, the decade of deregulation: Airlines. Banking. Gas pipelines and telecommunications. Trucking and railroads. ♦ Electric utilities: Still a regulated business. And likely to stay that way. At least in terms of retail sales to customers. Not so for electricity production. Competition is here and more regulatory barriers may tumble. ♦ The future: More players. Power companies, cogenerators, independent power producers. All seeking sales. Negotiating, using regulatory mechanisms. Perhaps, one day, bidding to build new generating plants. ♦ Policy makers' goals: Maximize efficiency. Minimize costs. ♦ Utility concerns: Can reliable service be maintained? Will fuel mix be diversified and secure? Will efficiency actually increase? ♦ Will the public really be better served? ♦ Utility leaders are speaking out in Washington. Playing an active role in shaping the changes that are affecting their industry. Representing the interests of customers and investors. And, at the same time, they're adopting strategies for success in a more competitive world.

TRENDS

Rate Increase Request to be Filed

Houston Lighting & Power Company is monitoring electric utility industry trends, and is playing an active role in shaping the direction of proposed regulatory changes at the Federal level. Of more immediate importance, however, are several issues specific to HL&P which will be decided by state regulators.

During the first half of 1988, HL&P expects to file a request for a rate increase, which is needed primarily to recover construction and operating costs associated with two new generating units. Unit 2 at the Limestone lignite plant went into service in December 1986. The first nuclear unit at the South Texas Project is expected to go into commercial operation later this year.

The amount of the rate increase granted will be influenced by a PUC prudence review of management, planning, and construction of STP. This type of review is commonly used by regulators to assess the planning and construction of complex projects in order to make appropriate rate decisions.

HL&P has submitted a substantial case to demonstrate that the owners were fully compensated for any possible imprudent costs by a $750 million settlement of a lawsuit against the former architect-engineer and constructor.

The Company believes that an equitable decision in the rate case will eliminate downward pressure on earnings from costs which are not yet reflected in electric rates. However, new rates may not be effective early enough to favorably impact 1988 results.

In the meantime, HL&P has asked the PUC for permission to use a special accounting treatment with respect to both Limestone Unit 2 and STP Unit 1, which would allow the Company to defer operating expenses and continue accruing a carrying charge. If granted, deferred accounting will help offset the negative impact of costs associated with operating these units from their in-service dates until a new rate order goes into effect.

HL&P employees have compiled volumes of supporting data to document the need for a base rate increase. A rate filing is anticipated during the first half of 1988.

HL&P President Don Sykora testified on electric utility industry issues before a U.S. House of Representatives subcommittee.

Cost Control Gives Competitive Edge

HL&P is pursuing a number of strategies for success in a competitive business environment.

The most obvious competitive strategy is to be the preferred, low-cost producer. HL&P has achieved substantial success in controlling costs company-wide through actions ranging from work force reductions to renegotiating fuel contracts.

This success is reflected in the Company's increasingly competitive rates. In 1986, the average rates HL&P charged its large industrial customers were the fifth lowest of 61 investor-owned utilities in 12 key states, and the lowest of nine investor-owned utilities in Texas. This was a significant improvement compared to 1985.

In 1987, HL&P underspent its operations and maintenance budget by 2.5 percent. Contributing to ongoing success in holding down costs is a staff reduction program, which has enabled the Company to decrease payroll costs substantially without a major layoff.

Target staffing levels established in mid-1986 have been achieved, with 914 positions eliminated through voluntary means, such as an early retirement program and employee reassignments.

Reassignments are continuing to help the Company utilize employees for high-priority activities without increasing staffing.

HL&P employees are playing an active role in controlling costs by working efficiently and by contributing their good ideas.

Employee Focus Groups have produced more than 1,500 ideas since their creation in 1983. During 1987, management approved almost 600 of approximately 850 suggestions. Savings from these ideas are expected to exceed $5.3 million in 1988.

Employees also maintained excellent customer service despite the need to do more with less. Nearly four out of five customers polled in the Annual Consumer Opinion Survey said they had a favorable opinion of HL&P.

Customer perceptions that HL&P provides quality service contributed to the high ratings, with 87 percent of those polled giving the Company high marks in this area. HL&P also received favorable ratings for good management, willingness to listen and respond, and being concerned about the cost of electric service.

The search for new cost-saving ideas led HL&P to test use of bar coding for accuracy and efficiency in materials management.

Houston-area students are staying comfortable and the school district is saving money since switching to electricity for heating in some schools. HL&P representatives help many customers identify beneficial new uses of electricity.

Marketing Benefits all Customers

Offering excellent service at a competitive price is one part of an effective marketing effort. Understanding customers and responding to their needs is another. HL&P has launched a major marketing initiative based on a detailed market and customer analysis conducted during 1987.

The new marketing programs being implemented all have one thing in common. They are designed to benefit all customers, not just those participating.

Increased sales help hold down the cost of electricity for everyone, because fixed costs are spread over a greater number of kilowatt-hours sold.

Economic development activities improve electricity sales and benefit the economy by bringing new businesses to the area and encouraging local expansion by those already here. During 1987, HL&P's economic development efforts led to the creation of 1,500 new jobs.

HL&P identifies prospects for possible business relocation or expansion through advertising, working with area economic development organizations, and referrals.

The Company also has expanded use of business research as a tool to target companies and industries which are expected to grow. Prospects are then contacted by HL&P representatives.

Besides communicating the benefits of the Houston area, HL&P is working to improve the region's economic appeal. The Company recently received approval from the PUC for a special electric rate which offers up to a 20 percent discount for basic industries creating new jobs in the area.

Offering a variety of rates to meet different customer needs also is an important tool in maintaining and increasing sales to existing customers. Interruptible rates, for example, provide a cost-effective alternative to self generation for some large customers who are able to accept the possibility of curtailments.

HL&P consultants help customers who are considering self generation projects to avoid those that do not measure up economically by explaining current rate options and providing forecasts of future energy costs.

During 1988, HL&P will pursue the residential market through a number of avenues, including stimulating construction of energy-efficient, all-electric homes. HL&P will promote the purchase of homes constructed under the "Good ¢ents"™ program.

In the commercial sector of HL&P's service area, electricity is economically superior to natural gas for heating and cooling. HL&P's marketing task is to educate architects, engineers, and customers about relative costs.

The Company also is working to strengthen relationships with trade groups, such as builders and heating and cooling contractors who are in a position to influence appliance and equipment selection.

HL&P is working to increase use of electricity for heating and other residential applications by promoting construction and purchase of energy-efficient electric homes.

Balancing supply with new demands

It used to be simple. ♦ Population increased, the economy expanded, and the use of electricity grew. Easy to plot, easy to plan for. ♦ Fuels were abundant and inexpensive. Gigantic power plants were needed. Economies of scale meant lower electric rates. It was the best of all worlds. ♦ Then, the Oil Embargo of 1973: Gas lines, fuel price shocks, shortages. And the inevitable legislation. Coal and nuclear plants were utilities' new options: Expensive to build, cheaper to fuel. ♦ Costs spiraled upward: Fuel escalations, construction increases, rising interest rates. And double-digit inflation. America pulled the plug. ♦ Usage patterns went awry. Conservation became a national obsession. Proven methods of forecasting electricity demand suddenly yielded only best guesstimates. Uncertainty reigned. ♦ In the mid-1980's: About face! An oversupply of oil and gas. Everyone knows it's temporary. But how temporary? And how severe will future shortages be? ♦ Today, a few of the giant power plants begun during the seventies are still coming on stream. Their legacy: Reliable electricity, less dependence on oil and gas. The price: Higher electricity costs. The result: Consumer resistance, regulatory reluctance to pass on costs. ♦ The immediate future: Flexible. Smaller new units, faster to build. Lower capital investments. Power purchases. And a myriad of new options steeped in new language. Demand side options. Conservation and load management to smooth the peaks in electricity use. Off-peak marketing to fill valleys and use available capacity. All with one end. Use plants efficiently, minimize costs. Longer term: A new cycle of construction likely. Building for new growth in the nineties, after demand is evident. Large-scale generating units that meet the test as least-cost options included as part of an overall power supply plan. ♦ Utilities are planning today for the new demands of tomorrow. The rules have changed. The goal has not. Strike a balance: Reliable service, reasonable rates, secure fuel supply, with a competitive return for investors.

TRENDS

Increased uncertainty about future demand for electricity is leading utilities to seek a balance among a variety of power supply options.

[illegible] is completing the last of its current power plant construction projects and has deferred a [illegible] plant until the late 1990s, while more stable demand is anticipated.

STP Starts Up, Construction Winds Down

HL&P reached a major milestone in its power plant construction program with completion of Unit 1 at the South Texas Project.

The Nuclear Regulatory Commission (NRC) issued a license for fuel loading and low-power operation of Unit 1 in August 1987. The first nuclear reaction, or initial criticality, took place March 8, 1988. HL&P estimates that three to five months of additional testing are required after initial criticality, to put Unit 1 in commercial operation.

STP Unit 2 was 86.2 percent complete at the end of 1987, on schedule for fuel loading in December 1988, and for commercial operation in June 1989. Completion of the plant will end HL&P's major plant construction for the near term.

Based on its September 1987 completion assessment, HL&P estimated that the total cost for the completed project would be $5.28 billion, net of proceeds from settlement of litigation with the former architect-engineer and constructor of STP.

This amount reflects an increase of about 5.5 percent, compared to the budget established in August 1982 when about two thirds of the construction work still lay ahead.

The estimated cost to HL&P for its 30.8 percent ownership is $2.4 billion, or $3,181 per kilowatt of capacity, including financing costs, or Allowance for Funds Used During Construction.

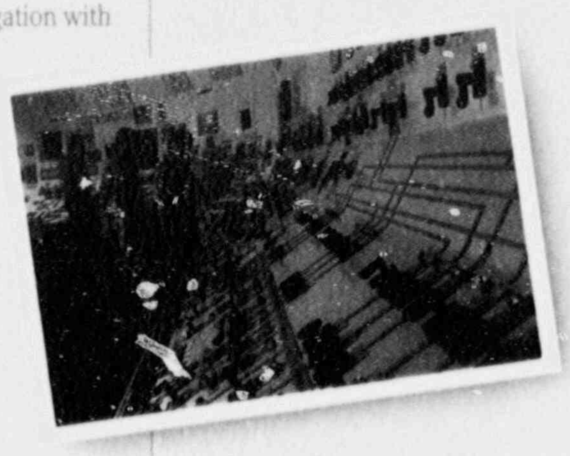
These estimates were based on a commercial operation date of March 1, 1988 for Unit 1. Commercial operation is now anticipated during the summer of 1988. The cost estimates are, therefore, subject to review, and HL&P anticipates that the cost of the total plant may increase by $100 to $150 million.

HL&P's interest in the plant will increase to 46.8 percent if the Company is able to conclude an agreement with the City of Austin. HL&P's estimated share of the completed cost would then be approximately $3.0 billion, based on the September 1987 cost estimate.

The agreement is subject to a number of events and conditions, including regulatory approval. However, if finalized, it will settle litigation filed by Austin against HL&P in 1983.

Under terms of the agreement, Austin would exchange its 400 megawatt interest in STP for ownership of an equal amount of capacity at HL&P's lignite-fired Limestone plant and a cash payment. The cash payment would cover purchase of nuclear fuel owned by Austin, reimbursement of construction expenses incurred by Austin during later stages of negotiations, legal fees, and settlement of an unrelated purchased power contract dispute. HL&P would assume the remaining construction costs for Austin's share of STP, effective September 1, 1987.

The agreement will allow Austin to meet its objective of discontinuing participation in STP. HL&P will benefit by acquiring additional nuclear capacity, to further diversify its fuel mix.



Operators at the South Texas Project took the Unit 1 reactor through the steps and tests leading up to the first nuclear reaction in March 1988.

HL&P Maintains Favorable Fuel Costs

By enabling HL&P to add low-cost uranium to its fuel mix, STP will contribute to the Company's goal of securing a diversified fuel supply with prices that will be stable over time.

Uranium will account for approximately 3* percent of the Company's energy mix in 1988 and 7* percent in 1989, after STP Unit 2 goes into service. Coal and lignite will make up 39* percent of HL&P's 1988 energy mix, while natural gas will drop to 43* percent.

This is a significant improvement in fuel diversification since 1977 when 100 percent of the Company's generating capacity was gas-fired.

**Based on HL&P's original 30.8 percent ownership of STP.*

In addition to completing plants that will use abundant fuels, HL&P is keeping its cost of natural gas among the lowest of major utilities in the nation. Despite a significant increase in the price of natural gas late in the year, the Company's unit cost of natural gas was about the same in 1987 as it was the previous year.

To maintain its competitive edge in natural gas costs, even as prices rise, HL&P is pursuing strategies to capitalize on the competitive forces which now exist in energy markets. This requires maximum flexibility in the timing of fuel purchases and the capability to choose from among many competing suppliers.

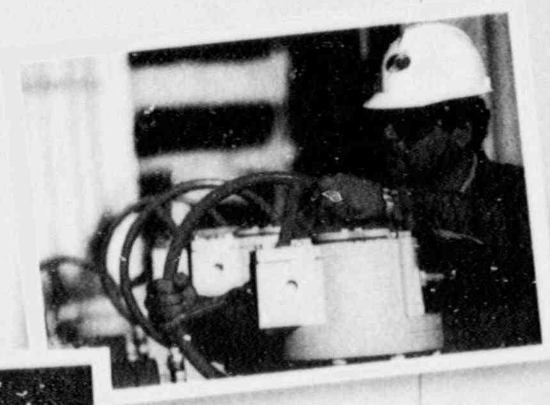
HL&P has completed the development of a comprehensive fuel delivery system. A major component of this system is a state-of-the-art gas storage facility, placed in service in October 1987, which will help ensure a stable natural gas supply and hold down gas costs by allowing the Company to control the timing of purchases.

HL&P also has added connections which provide access to several additional competing suppliers of natural gas.

The Company's coal costs were reduced beginning in January 1988 as a result of renegotiation of supply contracts by Utility Fuels, Inc., HI's coal supply subsidiary. The amendments to the coal supply contracts are expected to result in substantial savings to HL&P's customers over a 22-year period.

In August 1987, the STP Unit 1 reactor was loaded with about 17 million fuel pellets, each containing the energy equivalent of about one ton of coal.

HL&P has taken advantage of competitive forces in energy markets to achieve natural gas costs that are among the lowest of major utilities in the nation.



HL&P's diverse fuel mix, which now includes 39 percent coal and lignite, will help hold down fuel costs over the long term.*

Primary Fuels, Inc. (PFI) competes with large, integrated energy companies, companies owned by foreign governments, and other independents in a market that has undergone considerable turmoil in recent years. ♦ A dramatic oil and gas price collapse in mid-1986 was followed by some price improvement during 1987. However, at the end of 1987, oil prices remained unsettled. Natural gas prices, on the other hand, were showing signs of growing strength at year end. ♦ Conflicting estimates of near-term oil and gas prices abound. However, the general consensus is that prices will continue to rise gradually and gain momentum in the 1990s.

Oil prices unsettled, natural gas showing strength

PFI Results Improve

Primary Fuels posted greatly improved results during 1987, with earnings of $4.5 million, compared to a $27.7 million loss in 1986.

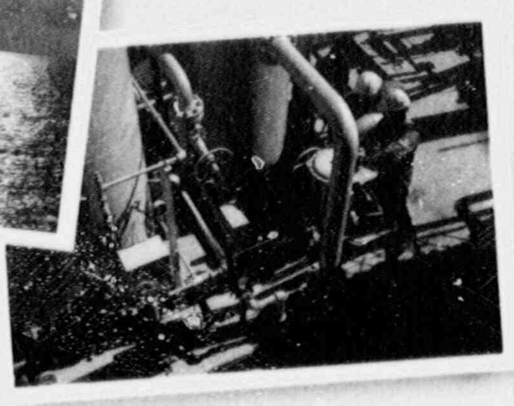
Higher oil prices and increased gas production contributed to the improvement in earnings during 1987, as did lower depreciation, depletion, and amortization expense. Earnings for 1987 also include pre-tax gains of $2.3 million associated with the purchase and subsequent sale of oil and gas properties located in Oklahoma, and $2.7 million related to the final settlement of various contracts.

Production during 1987 totaled 39.2 billion cubic feet (BCF) of gas and 3,887,000 barrels of oil, condensate, and natural gas liquids, compared to 31.2 BCF of gas and 4,114,000 barrels of oil, condensate, and natural gas liquids the previous year.

Revenues increased to $114.0 million in 1987, up from $105.4 million in 1986, as a result of improved oil prices and increased natural gas sales. Domestic oil prices averaged $16.08 per barrel in December 1987, up from $13.19 a year earlier. Domestic natural gas prices averaged $1.69 per thousand cubic feet in December 1987, compared to $1.74 per thousand cubic feet the previous year.

PFI's capital expenditures were $53.3 million in 1987 and are estimated at $57 million for 1988.

PFI acquired and began operating an oil and gas license in Argentina during 1987, where



The El Gordo field in Matagorda County, Texas is PFI's top producing property. It accounted for 18 percent of domestic natural gas revenues in 1987.

The following table sets forth the estimated net proved oil and gas reserves and the present value, discounted at 10%, of estimated future net revenues, as of the dates indicated. Estimated future net revenues were computed by applying year-end prices to year-end reserve quantities. Estimated future production and development costs were based on year-end costs, assuming continuation of existing economic conditions. Such information is based on reports prepared by Keplinger and Associates, Inc., DeGolyer and MacNaughton, H. K. van Poollen and Associates, Inc., and J. R. Butler and Company, independent energy consultants for 1985. For 1986, the information is based on reports by Keplinger and Associates, Inc., DeGolyer and MacNaughton and H. K. van Poollen and Associates, Inc., independent energy consultants. For 1987, the information is based on reports by K & A Energy Consultants, Inc., successors to Keplinger and Associates, Inc., Haley Engineering Inc., successors to H. K. van Poollen and Associates, Inc., and DeGolyer and MacNaughton, independent energy consultants. The Company emphasizes that the volumes of reserves shown below are estimates which are subjective in nature and are subject to later revision. The estimates are made using all available geological and reservoir data as well as production performance data. These estimates are reviewed annually and revised, either upward or downward, as warranted by additional performance data.

Proved Reserves	United States			Foreign		
	Natural Gas (MMCF)	Oil, Condensate And Natural Gas Liquids (Barrels)	Discounted Present Value of Future Net Revenues[1] (000)	Natural Gas (MMCF)	Oil, Condensate And Natural Gas Liquids (Barrels)	Discounted Present Value of Future Net Revenues[1] (000)
January 1, 1985	102,050	5,121,416	$268,446			
Revisions of Previous Estimates	830	(482,534)			110,650	
Extensions, Discoveries, and Other Additions	35,496	2,061,867				
Purchase of Reserves in Place	42,000	9,100,900		174,309	11,811,608	
Sale of Reserves in Place	(1,202)	(173,313)				
Production	(20,170)	(1,415,509)		(457)	(730,258)	
January 1, 1986	159,004	14,211,927	$363,803	173,852	11,192,000	$71,723[2]
Revisions of Previous Estimates	(8,904)	(1,055,591)		(50)	1,823,197	
Extensions, Discoveries, and Other Additions	8,797	261,861				
Production	(24,511)	(1,928,386)		(6,652)	(2,186,044)	
January 1, 1987	134,386	11,489,811	$174,547	167,150	10,829,153	$70,990[2]
Revisions of Previous Estimates	6,729	608,473		2,907	4,358,430	
Extensions, Discoveries, and Other Additions	8,672	160,528				
Purchase of Reserves in Place	13,260	135,473				
Sale of Reserves in Place	(12,277)	(182,197)				
Production	(29,120)	(1,626,148)		(10,047)	(2,261,045)	
January 1, 1988	121,650	10,585,940	$161,861	160,010	12,926,538	$71,520[2]
Proved Developed Reserves:						
As of January 1, 1986	153,816	13,997,935	$359,628	173,223	10,811,700	$70,356
As of January 1, 1987	130,691	11,487,811	$171,985	167,150	10,829,153	$70,990
As of January 1, 1988	121,210	10,584,219	$161,681	160,010	12,138,538	$67,850

[1] Estimates of future net revenues do not contain any provision for federal income taxes. Accordingly, the present value thereof does not constitute the Financial Accounting Standards Board's "standardized measure of discounted future net cash flows."

[2] As of January 1, 1988, 1987 and 1986, approximately 51%, 70% and 38% of the respective year's discounted present value of future net revenues attributable to foreign reserves is attributed to proved reserves located in Argentina, 30%, 17% and 39%, respectively, is attributed to proved reserves located in Greece, 16%, 11% and 18%, respectively, is attributed to proved reserves located in Indonesia, and 3%, 2% and 5%, respectively, is attributed to proved reserves located in Canada.

approximately 45 wells will be drilled over the next 24 months. Earnings and cash flow from this license are expected to have a positive impact in 1988. PFI and its partners also obtained three exploratory blocks in Argentina.

PFI is addressing continued volatility in energy markets by applying a conservative future pricing scenario when evaluating oil and gas prospects. The Company's strategic business plan calls for focusing its efforts on existing assets and expertise in West Texas, offshore in the Gulf of Mexico, and internationally.

Utility Fuels, Inc. (UFI) manages coal supply, transportation, and handling services. UFI's 1987 coal and lignite deliveries to six HL&P generating units represented about 2 percent of all coal supplied in the U.S., and about 6 percent of the western coal market, where UFI's supplies are concentrated. ♦ *The supply of coal nationwide currently exceeds demand, and growth in demand is forecast at less than 1 percent annually over the next decade, primarily because utility customers are planning few plant additions in the near future.*

Coal demand stable in near term

UFI Sales Increase

Utility Fuels achieved record highs in coal deliveries during 1987, and earnings of $24.2 million, up from $21.9 million the previous year. Revenues rose to $513.4 million, from $470.9 million in 1986.

Capital requirements continued to decline, and UFI met these requirements entirely from internally generated funds for the first time in its history.

With the second unit at Houston Lighting & Power Company's Limestone plant completing its first full year in service during 1987, UFI's lignite sales increased to 7.5 million tons, up 85 percent over 1986. Total coal and lignite sales were 15.8 million tons in 1987. Sales of Western coal were 8.3 million tons.

In an effort to keep HL&P's lignite costs as low as possible, UFI has contracted to purchase a bucketwheel excavator for use at the Jewett Mine, which supplies lignite for the Limestone plant. The bucketwheel system, scheduled for startup by late 1989, will be the second placed in operation in Texas. This equipment is more efficient than traditional mining equipment in removing the increased amounts of overburden encountered as the lignite seams being mined become deeper.

The capital cost for the bucketwheel excavator will be approximately $25 million. Total UFI capital expenditures will increase to $57 million in 1988 and $46 million in 1989, compared with $17 million in 1987.

Utility Fuels, like the coal industry in general, faces flat sales. HL&P has no plans for additional fossil-fueled generating capacity until the late 1990s. UFI has, therefore, adopted strategies aimed at achieving growth through developing new customers, offering new services, and acquiring new businesses.

In seeking new customers, UFI is focusing on the western coal market and emphasizing its ability to provide cost-effective service in fuel supply, transportation, handling, and management.

The Company also has begun marketing technical services related to coal supply and materials handling. These include customized operations training, engineering, and procedure development.

UFI continues to evaluate opportunities to acquire profitable coal supply operations or to invest in coal transportation and handling. With expertise in each of these areas, UFI can offer customers a coordinated fuel supply package with built-in efficiency and flexibility.

[illegible]
destinations for coal
in the U.S., [illegible]
ing deliveries of
nearly 9 million tons
of coal per year.

KBLCOM Incorporated (KBLCOM) owns a 50 percent interest in Paragon Communications, one of the top 20 cable television companies in the country. ♦ *Cable television is a $12 billion industry, growing by over 10 percent per year. In 1987, cable became the norm rather than the exception when the percentage of all American homes subscribing to cable service passed the 50 percent mark.*

Cable television comes of age

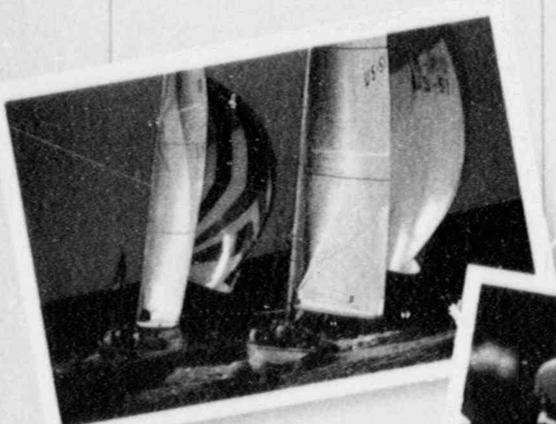
Advances in programming, including exclusive coverage of major sporting events, plus the proliferation of services such as home shopping, are giving people more reasons to bring cable into their homes. ♦ *The cable industry is maturing and changing. Rate deregulation, which took effect in January 1987, has led to market-based pricing, with a trend toward higher prices for basic cable service and lower prices for premium services.* ♦ *Meanwhile, ongoing consolidation is creating a smaller field of bigger players and increasing industry sophistication.*

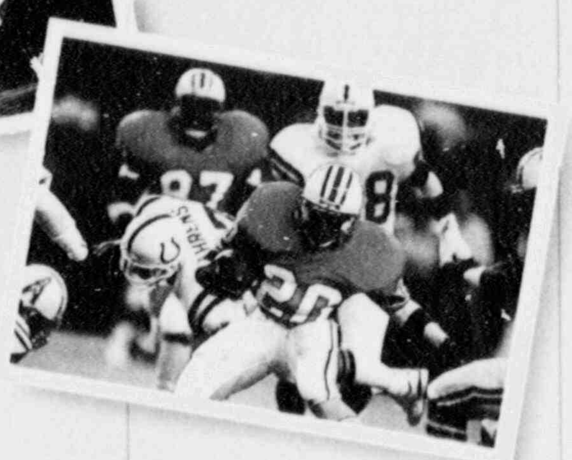
Paragon Improves Saturation, Service, and Profit Margins

Paragon Communications, a joint venture partnership, owns cable television operations serving over 650,000 customers in eight states. KBLCOM, an HI subsidiary, is participating in the partnership with American Television and Communications Corporation (ATC), a subsidiary of Time Incorporated.

Paragon systems are located in Texas, Arizona, the Tampa Bay area of Florida, the northeast, including a portion of Manhattan, and California. The California systems, located in the Los Angeles area, were acquired in June 1987.

Paragon's mission as a new company is to ensure a commitment to excellence through six measurable goals: a high level of customer satisfaction; a wide choice of quality programming; positive relationships with its communities; skilled and motivated employees; aggressively-managed growth;





Cable television sports exclusives such as N.F.L. Sunday night football (right) and the Americas Cup (above) are giving T.V. viewers more reasons to bring cable into their homes.

and financial results that meet realistic targets. Substantial progress is being made in these areas.

For example, Paragon has markedly improved its service as perceived by customers, according to the Company's semi-annual surveys. At the same time, the Company increased saturation, or the percentage of basic customers among the homes to which cable is available, to 54.1 percent at the end of 1987, up from 52.5 percent the previous year.

Gross profit margins improved as well, with an increase to 33.6 percent of revenue in 1987, up from 32.2 percent the previous year. In addition, Paragon's customer base grew by 55,000, with the acquisition of the Los Angeles County systems and other strategic acquisitions in close proximity to existing operations.

Paragon continues to seek opportunities to acquire attractive cable properties. Those located near current systems are of greatest interest because of the operating efficiencies that can be realized.

INNOVATIVE CONTROLS, INC.

Innovative Controls, Inc. (ICI) completed major start-up activities during 1987 and positioned itself to build market share in the years ahead.

The Company's new Houston manufacturing facility began full operation in July, with production of 70-watt sodium security lights. In December, the plant began producing ICI's new fluorescent shop lights.

In the first half of 1988, ICI will begin producing a number of products ranging from functional flood lights to decorative carriage and wall lights. The introductions will enable the Company to offer a well-rounded product line and should greatly enhance its ability to penetrate major retail chains.

Commitments already have been received from several major retail chains to begin or expand distribution of ICI products early in 1988, providing access to more than 1,000 new retail outlets.

ICI products feature the Company's proprietary electronic ballasts, which weigh just a fraction as much and consume substantially less energy than conventional ballasts. ICI's complete in-house research and engineering group continues to develop new applications for the ballasts.

In addition to technological superiority, ICI offers retailers very competitive pricing plus quality control and warranties that are unmatched in the industry. Every fixture is tested before it leaves the Houston plant and most are backed by a 10-year [illegible] warranty.

A fluorescent shop light introduced late in 1987 was the first of several new lights which will round out ICI's product line.

HOUSTON INDUSTRIES FINANCE, INC.

Houston Industries Finance, Inc. (HIF), which began purchasing the accounts receivable of Houston Lighting & Power Company in January 1987, recorded a $5.0 million profit during its first year of operation.

Through use of leverage and short-term financing, HIF is able to finance the receivables at a lower cost than HL&P would incur. This benefits HL&P customers, while allowing HI to earn a reasonable return on the equity invested in HIF.

HIF is using commercial paper, with a bank credit facility as a backup, to finance the receivables. The $300 million bank credit facility was established in July 1987. Later in the year, the finance subsidiary implemented its own commercial paper program. The commercial paper received a rating of Duff 1+ from Duff & Phelps and a rating of P-1 from Moody's. These are the highest short-term ratings given by the agencies.

The initial purpose of HIF is to purchase the receivables of HL&P and other HI subsidiaries. In the future, the finance subsidiary may also seek opportunities to acquire other high-quality receivables and may pave the way for HI diversification into the financial services industry.

DEVELOPMENT VENTURES, INC.

Development Ventures, Inc. (DVI) is a venture capital subsidiary formed in January 1987.

DVI invests in and assists with the development of emerging service and manufacturing businesses, serving markets demonstrating potential for above-average growth, primarily in the sunbelt. Priority is given to investments in Texas, especially in the area of Houston and the Texas Gulf Coast.

Investment emphasis is on expansion-stage growth companies and new business concept companies with proven products, services, or technologies that meet established market needs. Secondary consideration is given to new business startups. To complement its direct investments, DVI will commit a limited portion of its portfolio to other venture capital funds.

In addition to earning an attractive return on committed funds, the venture capital investments of DVI are expected to be an important component of the Houston Industries corporate development strategy. Through relatively small commitments, risk can be minimized while broadening HI's experience to include new industries. Out of this process, HI expects at least one new area of business to be identified for diversification and significant future growth.

To date, four investments have been completed. Two of these are in other venture capital funds. One fund is focused on technologies which are primarily for application in the utility industry. The other focuses on startup companies, particularly those in the Houston area. DVI also has made direct investments in the commercialization of space and in the broad field of health care, two industries that offer rapid expansion opportunities in Texas and around the world.

TABLE OF CONTENTS

QUARTERLY HIGH AND LOW STOCK PRICES

on the New York Stock Exchange and Composite Tape

*Dividends declared per share

The following table sets forth selected financial data with respect to the Company's consolidated financial condition and consolidated results of operations and should be read in conjunction with the Consolidated Financial Statements and the related notes included elsewhere herein.

	Year Ended December 31,				
(Thousands of Dollars, except per share amounts)	1987	1986	1985	1984	1983
Revenues	$3,628,213	$3,535,968	$4,061,812	$4,181,575	$3,992,758
Net income	$ 434,958	$ 424,935	$ 434,126	$ 331,146	$ 299,857
Earnings per share	$ 3.74	$ 3.81	$ 4.13	$ 3.69	$ 3.50
Cash dividends declared per common share	$ 2.86	$ 2.76	$ 2.60	$ 2.44	$ 2.28
Return on average common equity	13.6%	14.5%	16.7%	15.7%	15.6%
Ratio of earnings to fixed charges:					
Including AFUDC	2.86	2.76	2.96	2.87	3.01
Excluding AFUDC	2.14	2.00	2.23	2.43	2.79
At Year-End:					
Book value per common share	$ 28.33	$ 27.19	$ 25.86	$ 24.31	$ 23.27
Market price per common share	$ 30.00	$ 34.75	$ 28.00	$ 22.50	$ 19.38
Market price as a percent of book value	106%	128%	108%	93%	83%
At Year-End:					
Total assets	$9,727,688	$9,027,817	$8,625,667	$7,525,977	$6,483,035
Long-term debt (including current maturities)	$3,136,852	$3,208,160	$2,952,926	$2,683,319	$2,274,616
Capitalization:					
Common stock equity	48%	47%	46%	45%	46%
Cumulative preferred stock	6%	5%	6%	5%	5%
Long-term debt (including current maturities)	46%	48%	48%	50%	49%
Capital Expenditures:					
Construction and nuclear fuel expenditures (excluding AFUDC)	$ 662,054	$ 755,273	$ 893,053	$ 997,982	$ 913,825
Oil and gas additions	$ 41,488	$ 16,187	$ 224,150	$ 65,928	$ 65,858
Cable television investment	$ 58,336	$ 26,046			
HL&P Selected Data:					
Percent of construction expenditures financed internally from operations	29%	35%	39%	37%	42%
Ratio of earnings to fixed charges:					
Including AFUDC	3.35	3.36	3.76	3.55	3.50
Excluding AFUDC	2.41	2.42	2.84	2.99	3.22
AFUDC as a percent of net income	52%	52%	45%	31%	17%

	Year Ended December 31,		
	1987	1986	1985
Operating Revenue (Thousands of Dollars):			
Residential	$ 1,078,934	$ 1,071,356	$ 1,244,002
Commercial	690,078	707,386	831,277
Industrial	993,610	1,024,459	1,353,162
Street lighting–government and municipal	17,786	16,683	16,888
Other electric utilities	79,503	68,990	106,273
Total	2,859,911	2,888,874	3,551,602
Miscellaneous electric revenues	140,921	70,866	(18,238)
Total	$ 3,000,832	$ 2,959,740	$ 3,533,364
Electric Plant Investment (Thousands of Dollars):			
Gross additions	$ 857,045	$ 938,075	$ 950,241
Total plant investment	$ 9,799,877	$ 8,993,854	$ 8,137,530
Accumulated depreciation	$ 1,530,543	$ 1,351,412	$ 1,203,039
Percent of total plant investment	15.6%	15.0%	14.8%
Generating Statistics:			
Steam electric stations economy–Btu per net KWH generated	10,457	10,434	10,331
Net generating capability (MW)–at time of maximum system load*	13,755	13,258	13,913
Maximum system load (MW)**	10,302	10,556	10,618
Electric plant in service per KW of maximum system load ($)	664	618	557
General Statistics:			
Kilowatt hour sales (000)	55,911,327	54,007,557	55,968,716
Number of customers	1,306,328	1,303,205	1,316,316
Average residential use (KWH)	12,812	12,675	12,961
Average residential revenue per KWH	7.34¢	7.32¢	8.30¢
Average residential fuel revenue per KWH	1.83¢	2.17¢	3.40¢

*Including purchased power and cogeneration capability of 1,295 MW, 1,395 MW and 1,595 MW in 1987, 1986 and 1985, respectively.

**Excluding interruptible demand.

Results of Operations

Consolidated net income for 1987 was $435 million, up $10 million from 1986 and up $1 million from 1985. Consolidated earnings per share decreased to $3.74 for the current year as compared to $3.81 per share in 1986, while 1985 earnings were $4.13 per share.

Houston Lighting & Power Company (HL&P), the Company's principal operating subsidiary, contributed $3.51 to the 1987 consolidated earnings per share on income after preferred dividends of $409 million. Utility Fuels, Inc. (Utility Fuels) contributed $.21 per share on earnings of $24.2 million while Primary Fuels, Inc. (Primary Fuels) reported income of $4.5 million or $.04 per share. The Company's other subsidiaries posted a combined loss of $.10 per share.

HL&P's 1987 income after preferred dividends fell $26 million from 1986 and $47 million from the record earnings of 1985. Allowance for funds used during construction (AFUDC) accounted for 52% of earnings in both 1987 and 1986 compared to 45% in 1985. AFUDC is a non-cash item of net income which represents the cost of funds used to finance construction projects and is capitalized as part of the cost of the assets being constructed. Decreases in AFUDC in 1987 were primarily related to a reduction in the net-of-tax AFUDC rate and the commencement of commercial operation of Unit No. 2 of the Limestone Electric Generating Station (Limestone). Increases in AFUDC in 1986 resulted from increased levels of investment in construction without corresponding increases in the amount of construction included in rate base and earning a current cash return.

The decline in HL&P's 1987 income is attributable to increased expenses principally associated with Limestone, which expenses are not yet fully reflected in electric rates, partially offset by the reduction of the federal corporate income tax rate due to the Tax Reform Act of 1986. Earnings were positively affected by base rate increases allowed by the City of Houston and the Public Utility Commission of Texas (Utility Commission) in July and December 1986, respectively.

Houston Lighting & Power Company

KILOWATT HOUR SALES

in billions

Houston Lighting & Power Company

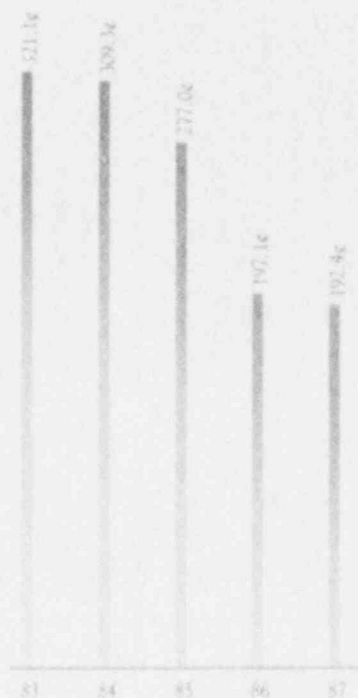
AVERAGE RESIDENTIAL REVENUE

cents per kilowatt hour

Houston Lighting & Power Company

AVERAGE COST OF FUEL

cents per million BTU



Electric operating revenues increased 1% and declined 16% for the years 1987 and 1986, respectively. The increase in revenues in 1987 is primarily due to higher base revenues from rate increases implemented in 1986. Kilowatt hour (KWH) sales were up 3.5% during 1987 and down 3.5% in 1986. The majority of the increases was due to off-system sales and sales to industrial customers on an interruptible basis, both of which provide minimal contribution to base electric revenues. Residential KWH sales increased by .5% in 1987 and declined 2.4% in 1986. Commercial KWH sales declined by 2.2% in 1987 and .5% in 1986. Industrial KWH sales, which account for approximately half of HL&P's overall sales, were up 4.8% and down 4.5% for 1987 and 1986, respectively. However, most of the increase was due to sales made on an interruptible basis as described above.

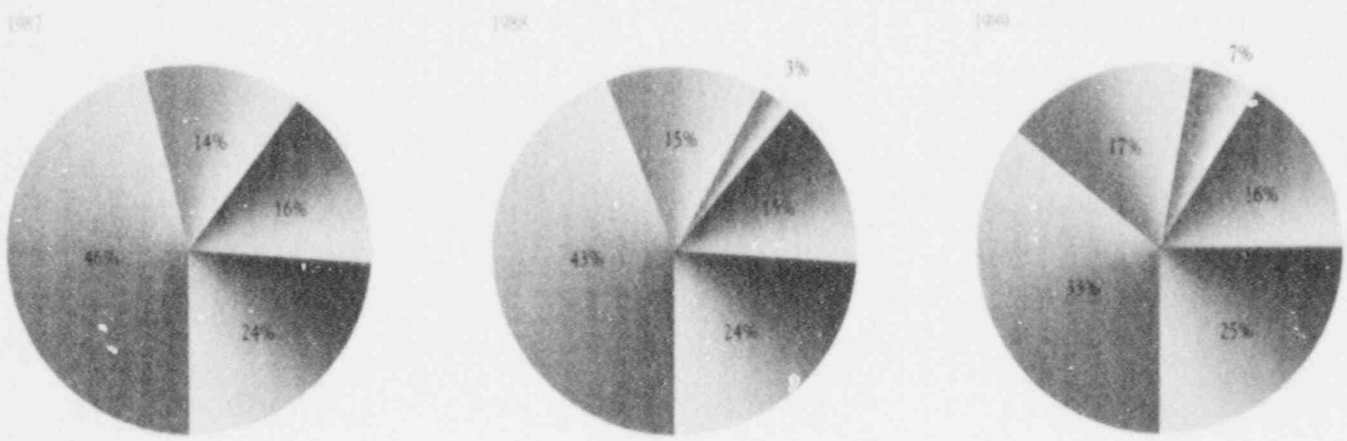
Fuel expense increased $47 million in 1987 and declined $485 million in 1986. The increase in 1987 was primarily due to increased generation, partially offset by decreases in the price paid for fuel. The average cost of fuel used by HL&P during 1987 was $1.92 per million Btu as compared with $1.97 for 1986 and $2.77 for 1985. The combined cost of fuel used by HL&P and the fuel portion of purchased power during 1987 was 1.86 cents per KWH as compared with 2.10 cents in 1986 and 3.02 cents in 1985. Purchased power expense decreased 10% in 1987 and 5% in 1986 due to decreases in purchases of energy from cogenerators.

Electric operating and maintenance expenses in 1987 increased 9% or $52 million when compared to 1986. In 1986, operating and maintenance expenses decreased $33 million or 6% when compared to 1985. The increase in 1987 was due primarily to increases in operation and maintenance expenses related to Limestone and in administrative and general expenses. The decrease in 1986 was primarily due to a reduction in transmission expenses, customer expenses and administrative and general expenses.

In January 1987, following the December 1986 commencement of commercial operation of Limestone Unit No. 2, HL&P filed a petition with the Utility Commission requesting interim accounting treatment to capitalize costs and to continue the accrual of AFUDC associated with Unit No. 2 from the time it was placed in commercial operation until rates reflecting the costs of such unit are placed in effect. Electric rates do not currently reflect approximately $174 million of the project's cost or any provision for operating expenses, non-reconcilable lignite mining and handling costs, taxes or depreciation related to Unit No. 2, estimated to be $57 million on an annual basis. In July 1987, a similar request was made for the first unit of the South

ENERGY MIX*

Houston Lighting & Power Company



GAS LIGNITE NUCLEAR COAL COGENERATION & OFF-SYSTEM PURCHASES**

*Based on Btu requirements and on HL&P's original 30.8% share of the South Texas project.
**Substantially all purchased power and cogeneration is expected to be gas-fired.

Texas project once it goes into commercial operation. The annualized effect of operating expenses, taxes, depreciation and AFUDC related to Unit No. 1 is estimated to be $230 million based on HL&P's 30.8% interest ($290 million based on a 46.8% interest), none of which is reflected in electric rates. The Utility Commission has not ruled on either request. Until rate relief is obtained which reflects Limestone Unit No. 2 as plant in service or the requested accounting treatment or other regulatory action is granted with respect to Limestone Unit No. 2, operating results of HL&P and the Company will be adversely affected. Upon the commencement of commercial operation of Unit No. 1 of the South Texas project, the operating results of HL&P and the Company will be more severely impacted until similar regulatory relief is granted with respect to such unit.

Utility Fuels' 1987 operating results showed improvement over 1986, primarily as a result of increased sales of lignite fuel for use at HL&P's Limestone Unit No. 2. Net income in 1987 was $24.2 million compared to $21.9 million in 1986 and $12.2 million in 1985. Utility Fuels' fuel supply contract with HL&P generally allows Utility Fuels to recover its costs plus a fixed return on its net investment in facilities. As a result of the regulation of affiliated costs by the Utility Commission, a portion of Utility Fuels' billings are not recoverable through HL&P's electric rates.

Primary Fuels posted income of $4.5 million, rebounding from losses of $27.7 million in 1986 and $35 million in 1985. The oil and gas subsidiary's operating results have improved primarily due to increased natural gas production, higher oil prices and reduced depreciation, depletion and amortization expense. Primary Fuels' natural gas production increased to 39,167 MMCF this year from 31,163 MMCF in 1986 and 20,627 MMCF in 1985. The average price per barrel of oil sold by Primary Fuels was $15.74 in 1987 as compared to $13.61 and $25.44 in 1986 and 1985, respectively. Primary Fuels' depreciation, depletion and amortization expense for 1986 and 1985 reflected writedowns of $12.4 million and $23.6 million, respectively, related to the impairment of certain oil and gas properties resulting from steep declines in oil and gas prices. Earnings for 1987 also include gains of $2.3 million associated with the purchase and subsequent sale of oil and gas properties and $2.7 million related to the final settlement of various contracts.

KBLCOM Incorporated (KBLCOM) experienced a net loss of $10.6 million in 1987, the first full year of operations for the Company's cable television subsidiary, compared to a $6.5 million loss in 1986. Established in June 1986, KBLCOM holds a 50 percent interest in Paragon Communications (Paragon), a partnership which operates cable television systems in several states. KBLCOM's earnings outlook for the near future is dependent to a large degree on Paragon's success in achieving increased basic cable saturation in existing markets and the acquisition of additional cable properties near those presently held.

In prior years, the Company's operating results were adversely affected by the lag in recovery of increased costs through electric rates due primarily to relatively high rates of inflation. The rate of inflation, however, has moderated over the last several years, and the Company and its subsidiaries have not been significantly impacted by the effects of inflation.

Liquidity and Capital Resources

Liquidity and capital resources are affected primarily through capital programs. The capital requirements for 1987, and as estimated for 1988 through 1990, are as follows:

Millions of Dollars	1987	1988	1989	1990
Construction and nuclear fuel (excluding AFUDC)[1]	$645	$495	$444	$ 368
Coal handling facilities and lignite mining and handling facilities	17	57	46	24
Oil and gas exploration and development[2]	53	57		
Equity investment in cable television joint venture[3]	58			
Maturities of long-term debt	53	58	58	3
Total	$826	$667	$548	$ 395

[1] These amounts do not include expenditures on projects for which HL&P expects to be reimbursed by customers or cogenerators. These amounts also do not reflect the possible acquisition by HL&P of an additional 16% interest in the South Texas project presently owned by the City of Austin (Austin), which would increase the estimated construction and nuclear fuel expenditures by $205 million for the 1988–1990 period, $92 million of which is related to the reimbursement of costs incurred by Austin prior to 1988 and the purchase of Austin's nuclear fuel.

[2] Primary Fuels' expenditures for oil and gas exploration subsequent to 1988 are dependent upon the results of its 1988 exploration and development program and factors affecting the oil and gas industry.

[3] The amount shown represents investments by KBLCOM in Paragon and several smaller partnerships.

Construction and nuclear fuel expenditures for the 1988-1990 period principally represent estimated costs of HL&P's construction program and reflect the cost estimate for the South Texas project adopted in December 1987 (assuming a commercial operation date for Unit No. 1 of March 1, 1988). The estimated expenditures for coal handling facilities and lignite mining and handling facilities are expected to be incurred by Utility Fuels in connection with HL&P's lignite projects. These amounts reflect the modification of the scheduled in-service dates for the two lignite units at the Malakoff Electric Generating Station as discussed in Note 11 to the Consolidated Financial Statements.

HL&P expects to finance a portion of its construction program through funds generated internally from operations. The extent to which HL&P is able to fund its capital requirements from internal funds is dependent, to a large degree, on regulatory practices which determine the amount and timing of recovery of investments in new plant facilities, depreciation rates, recovery of operating expenses and the opportunity to earn a reasonable rate of return on its invested capital. It is presently estimated that during 1988, 10% to 20% of HL&P's construction program can be financed through internally generated funds from operations. Internally generated funds for subsequent years will be primarily dependent on the regulatory treatment of HL&P's investment in the South Texas project. The balance of HL&P's construction program is expected to be financed through external sources, primarily sales of long-term debt, preferred stock and additional shares of common stock to the Company, and, on an interim basis, the issuance of short-term debt securities. See Note 5 to the Consolidated Financial Statements for a discussion of short-term financing.

In March 1987, HL&P issued $391 million aggregate principal amount of a new 9% series of first mortgage bonds due 2017 in exchange for a like principal amount of outstanding high coupon first mortgage bonds. An additional $140 million principal amount of high coupon first mortgage bonds was redeemed under the Replacement Fund provisions of HL&P's Mortgage and Deed of Trust and was retired by the bond trustee in May 1987. In February 1988, $48 million principal amount of HL&P's 13¾% series first mortgage bonds due 1991 was redeemed at 100% of the principal amount plus accrued interest. These actions are part of a continuing program to reduce HL&P's long-term debt costs.

In June 1987, HL&P sold 1,000,000 shares of $8.50 cumulative preferred stock which are subject to mandatory redemption. The mandatory redemption provision requires HL&P to redeem 200,000 shares annually beginning on June 1, 1993. HL&P received net proceeds of $99 million from the sale.

During 1987, HL&P received approximately $128 million from the proceeds of previously issued pollution control revenue bonds and first mortgage bonds, which proceeds had been held in trust. Approximately $87 million (including interest earned on funds held in trust) was held in trust at December 31, 1987. Substantially all the funds held in trust are expected to be drawn down by HL&P in 1988 and 1989 to fund qualifying construction expenditures. On November 1, 1987, $40 million principal amount of HL&P's 4¼% series first mortgage bonds matured. In January 1988, HL&P issued in a private placement $400 million principal amount of 9¼% first mortgage bonds which will mature in approximately equal principal amounts in each of the years 1991, 1992, and 1993.

HL&P's capitalization ratios at December 31, 1987 consisted of 45% long-term debt, 7% preferred stock and 48% common equity, with similar ratios expected to be maintained in the future, assuming HL&P is able to obtain rate relief at levels comparable to those obtained in the past.

Utility Fuels and Primary Fuels expect to fund a substantial part of their capital requirements through internally generated funds. External funding will be met by advances from the Company.

KBLCOM's future capital requirements will be primarily dependent upon the acquisition of additional cable television systems by KBLCOM or Paragon. Any such requirements will be met through advances or capital contributions by the Company. In June 1987, KBLCOM contributed approximately $42 million to Paragon in connection with the permanent financing for Paragon and the acquisition of additional cable television systems in 1987. KBLCOM also invested $11 million in other partnerships which hold certain cable television systems and other assets formerly owned by Group W Cable, Inc. pending disposition of such systems and assets.

Houston Industries Finance, Inc. (Houston Industries Finance) began purchasing HL&P's customer accounts receivable in January 1987. The use of leverage and short-term borrowings by Houston Industries Finance allows the receivables to be financed at a lower cost than would traditionally be incurred by HL&P. The financing requirements of the new subsidiary are met through short-term bank loans and the issuance of commercial paper. Houston Industries Finance has entered into a bank revolving credit facility which provides for borrowings of up to $300 million aggregate principal amount. This facility is available to make direct borrowings or to support the issuance of commercial paper.

The Tax Reform Act of 1986 (the Tax Act) includes a number of provisions that have adversely affected the Company's operating subsidiaries, particularly HL&P. Although the Tax Act reduced corporate income tax rates, it eliminated investment tax credits effective January 1, 1986 (except with respect to certain transition properties, including the South Texas project), eliminated current deductions for interest and property taxes during construction and made substantial changes to the calculation of the alternative minimum tax. This latter provision effectively provides for the inclusion of up to one half of the amount of AFUDC, a non-cash item of financial reporting income, as taxable income in determining the alternative minimum tax. These and other provisions of the Tax Act are expected to reduce the amount of cash flow generated from operations and therefore increase the Company's reliance on external sources of funds.

Changes in Accounting Standards

In December 1986, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 90, "Regulated Enterprises-Accounting for Abandonments and Disallowances of Plant Costs," which becomes effective for fiscal years beginning after December 15, 1987. SFAS No. 90 requires the future revenue that is expected to result from the regulator's inclusion of the cost of an abandoned plant in allowable costs for ratemaking purposes to be reported at its present value when the abandonment becomes probable. If the carrying amount of the abandoned plant exceeds that present value, a loss would be recognized. In addition, SFAS No. 90 requires any costs of a recently completed plant which are disallowed to be recognized as a loss when such a disallowance becomes probable and the amount of the disallowance is reasonably estimable. If part of the cost is disallowed indirectly (such as a disallowance of return on investment on a portion of the plant), an equivalent amount of cost shall be deducted from the reported cost of the plant and recognized as a loss. Finally, SFAS No. 90 specifies that AFUDC should be capitalized only if its subsequent inclusion in allowable costs for ratemaking purposes is probable. See Note 10 to the Consolidated Financial Statements for a discussion of the prudence review of the South Texas project by the Utility Commission.

HL&P recorded a partial loss on abandonment of the Allens Creek Nuclear Project (Allens Creek) in 1982, and is currently amortizing the recoverable amount over a ten year period. HL&P believes that the application of SFAS No. 90 to Allens Creek would not materially affect the results of operations. See Notes 8 and 12 to the Consolidated Financial Statements for discussions of Allens Creek.

In August 1987, the FASB issued SFAS No. 92, "Regulated Enterprises–Accounting for Phase-in Plans." SFAS No. 92 requires allowable costs deferred for future recovery under a phase-in plan related to plants completed before January 1, 1988, and plants on which substantial construction has been performed before January 1, 1988, to be capitalized as a deferred charge if each of four criteria is met. Those criteria are (a) the plan has been agreed to by the regulator, (b) the plan specifies when recovery will occur, (c) all allowable costs deferred under the plan are scheduled for recovery within ten years of the date when deferrals begin, and (d) the percentage increase in rates scheduled for each future year under the plan is not greater than the percentage increase in rates scheduled for each immediately preceding year. SFAS No. 92 does not permit the equity portion of AFUDC to be capitalized other than during construction or as part of a qualified phase-in plan. The provisions of SFAS No. 92 must be adopted for fiscal years beginning after December 15, 1987. See Note 10 to the Consolidated Financial Statements for a discussion of the effect of SFAS No. 92 on HL&P's deferred accounting request for Unit No. 1 of the South Texas project.

In December 1987, the FASB issued SFAS No. 96, "Accounting for Income Taxes," which becomes effective for fiscal years beginning after December 15, 1988. SFAS No. 96 requires, among other things, the liability method of recognition for all temporary differences, requires that deferred tax liabilities and assets be adjusted for an enacted change in tax laws or rates and prohibits net-of-tax accounting and reporting. Certain provisions of SFAS No. 96 provide that regulated enterprises are permitted to recognize such adjustments as regulatory assets or liabilities if it is probable that such amounts will be recovered from or returned to customers in future rates. The Company is currently evaluating the effects of SFAS No. 96 but does not expect the new pronouncement to have a material effect on the Company's financial position or results of operations. The Company presently anticipates adopting SFAS No. 96 in 1989.

	Year Ended December 31,		
(Thousands of Dollars)	1987	1986	1985
Revenues:			
Electric	$3,000,832	$2,959,740	$3,533,364
Fuel sales	513,394	470,852	418,063
Oil and gas	113,987	105,376	110,385
Total	3,628,213	3,535,968	4,061,812
Expenses:			
Electric:			
Fuel	981,922	935,169	1,420,262
Purchased power	379,497	421,893	442,802
Operation and maintenance	613,355	561,406	594,576
Taxes other than federal income taxes	151,667	146,791	140,185
Cost of fuel sold	430,754	392,777	372,274
Oil and gas operating expenses	47,703	53,440	79,833
Depreciation, depletion and amortization	285,847	297,911	267,004
Total	2,890,745	2,809,387	3,316,936
Operating Income	737,468	726,581	744,876
Other Income (Expense):			
Allowance for other funds used during construction	143,584	170,348	154,246
Other–net	10,199	(9,002)	5,193
Total	153,783	161,346	159,439
Fixed Charges:			
Interest on long-term debt	270,958	287,506	259,363
Other interest	44,747	42,137	48,608
Allowance for borrowed funds used during construction	(109,160)	(109,369)	(104,573)
Preferred dividends of subsidiary	31,406	26,817	26,602
Total	237,951	247,091	230,000
Income Before Federal Income Taxes	653,300	640,836	674,315
Federal Income Taxes	218,342	215,901	240,189
Net Income	$ 434,958	$ 424,935	$ 434,126
Earnings Per Common Share	$ 3.74	$ 3.81	$ 4.13
Weighted Average Common Shares Outstanding (000)	116,322	111,593	105,014

See Notes to Consolidated Financial Statements.

	Year Ended December 31,		
(Thousands of Dollars)	1987	1986	1985
Balance at Beginning of Year	$1,223,409	$1,106,221	$ 945,227
Add–Net Income	434,958	424,935	434,126
Total	1,658,367	1,531,156	1,379,353
Deduct–Common Stock Dividends:			
1987, $2.86; 1986, $2.76; 1985, $2.60 (per share)	332,458	307,747	273,132
Balance at End of Year	$1,325,909	$1,223,409	$1,106,221

See Notes to Consolidated Financial Statements.

	December 31,	
(Thousands of Dollars)	1987	1986
Assets		
Property, Plant and Equipment–At Cost:		
Electric plant:		
Production	$ 3,894,100	$3,747,442
Transmission	640,423	601,084
Distribution	1,845,618	1,747,216
General	456,232	431,048
Construction work in progress	2,648,682	2,170,700
Nuclear fuel	131,323	126,190
Held for future use	180,333	167,008
Electric plant acquisition adjustments	3,166	3,166
Coal handling equipment and mining property	542,549	527,508
Oil and gas property	458,947	430,668
Other property	13,217	7,931
Total	10,814,590	9,959,961
Less accumulated depreciation, depletion and amortization	1,868,791	1,627,621
Property, plant and equipment–net	8,945,799	8,332,340
Current Assets:		
Cash and temporary investments	1,058	13,512
Working funds and special deposits	569	34,858
Accounts receivable:		
Customers	124,333	110,741
Others	65,891	64,611
Fuel stock, at lifo cost:		
Oil and gas	18,698	16,583
Coal and lignite	49,478	41,286
Materials and supplies, at average cost	108,046	87,989
Other	14,068	17,588
Total current assets	382,141	387,168
Other Assets:		
Cable television investment	70,423	16,036
Recoverable cancelled project costs	36,129	43,382
Unamortized debt expense and premium on reacquired debt	69,348	49,342
Deferred debits	223,848	199,549
Total other assets	399,748	308,309
Total	$ 9,727,688	$9,027,817

See Notes to Consolidated Financial Statements.

(Thousands of Dollars)	December 31, 1987	December 31, 1986
Capitalization and Liabilities		
Capitalization:		
Common Stock Equity:		
Common stock, no par; authorized, 200,000,000 shares; outstanding 117,660,632 shares at December 31, 1987 and 114,124,615 shares at December 31, 1986	$2,007,466	$1,879,218
Retained earnings	1,325,909	1,223,409
Total common stock equity	3,333,375	3,102,627
Preference Stock, no par; authorized 10,000,000 shares; none outstanding		
Cumulative Preferred Stock of Subsidiary: (statements on following page)		
Not subject to mandatory redemption	341,319	341,319
Subject to mandatory redemption	99,055	
Total cumulative preferred stock	440,374	341,319
Long-Term Debt:		
Debentures, 9⅝% series due 1996	199,234	199,139
Long-term debt of subsidiaries (statements on following page)	2,879,915	2,956,254
Total long-term debt	3,079,149	3,155,393
Total capitalization	6,852,898	6,599,339
Current Liabilities:		
Notes payable	725,820	220,292
Accounts payable	264,256	276,166
Taxes accrued	87,138	108,898
Interest accrued	74,870	75,493
Accrued liabilities to municipalities	70,685	72,263
Current portion of long-term debt	57,703	52,767
Fuel cost over recovery		94,309
Other	49,696	57,349
Total current liabilities	1,330,168	957,537
Deferred Credits:		
Accumulated deferred federal income taxes	902,153	811,096
Unamortized investment tax credit	557,674	561,376
Other	84,795	98,469
Total deferred credits	1,544,622	1,470,941
Commitments and Contingencies		
Total	$9,727,688	$9,027,817

See Notes to Consolidated Financial Statements.

(Thousands of Dollars)	December 31, 1987	December 31, 1986
Cumulative Preferred Stock, no par; authorized 10,000,000 shares; outstanding 4,447,397 shares at December 31, 1987 and 3,447,397 shares at December 31, 1986 (entitled upon involuntary liquidation to $100 per share)		
Houston Lighting & Power Company:		
Not subject to mandatory redemption:		
$4.00 series, 97,397 shares	$ 9,740	$ 9,740
$6.72 series, 250,000 shares	25,115	25,115
$7.52 series, 500,000 shares	50,225	50,225
$9.52 series, 400,000 shares	39,372	39,372
$9.08 series, 400,000 shares	39,395	39,395
$8.12 series, 500,000 shares	50,098	50,098
$9.04 series, 300,000 shares	29,573	29,573
"A" series, 500,000 shares	48,809	48,809
"B" series, 500,000 shares	48,992	48,992
Total	341,319	341,319
Subject to mandatory redemption:		
$8.50 series, 1,000,000 shares	99,055	
Total cumulative preferred stock	$ 440,374	$ 341,319

Long-Term Debt:		
Houston Lighting & Power Company:		
First mortgage bonds:		
4¾% series, due 1987		$ 40,000
3% series, due 1989	$ 30,000	30,000
4⅛% series, due 1989	25,000	25,000
13⅞% series, due 1991	48,473	65,301
15⅛% series, due 1992	52,662	68,712
4½% series, due 1992	25,000	25,000
5¼% series, due 1996	40,000	40,000
5¼% series, due 1997	40,000	40,000
6¼% series, due 1997	35,000	35,000
6¾% series, due 1998	35,000	35,000
7½% series, due 1999	30,000	30,000
7¼% series, due 2001	50,000	50,000
7½% series, due 2001	50,000	50,000
8⅛% series, due 2004	100,000	100,000
10[illegible]% series, due 2004	35,407	100,000
8¼% series, due 2005	125,000	125,000
8⅜% series, due 2006	125,000	125,000
8⅛% series, due 2007	125,000	125,000
8⅞% series, due 2008	125,000	125,000
9¼% series, due 2008	100,000	100,000

	December 31,	
(Thousands of Dollars)	1987	1986
11¼% series, due 2009		$ 125,000
12% series, due 2010		100,000
12⅛% series, due 2013		7,944
11⅝% series, due 2015		200,000
9% series, due 2017	$ 390,519	
7⅛% pollution control series, due 2016	68,000	68,000
7⅛% pollution control series, due 2018	50,000	50,000
Funds on deposit with Trustee	(12,612)	(39,112)
Total first mortgage bonds	1,692,449	1,845,845
Pollution control revenue bonds:		
Gulf Coast 1978 series, 9½%, due 1998	19,200	19,200
Gulf Coast 1980-T series, Floating Rate, due 1998	5,000	5,000
Brazos River 1983 series, 10½%, due 2003	25,000	25,000
Gulf Coast 1974 series, 7⅜%, due 2004	18,000	18,000
Brazos River 1985 A2 series, 9¼%, due 2005	10,000	10,000
Gulf Coast 1982 series, 9⅞%, due 2012	12,100	12,100
Brazos River 1982 series, 9⅞%, due 2012	42,800	42,800
Brazos River 1983 series, 10⅛%, due 2013	75,000	75,000
Brazos River 1985 A1 series, 9⅞%, due 2015	100,000	100,000
Brazos River 1985 B series, Floating Rate, due 2015	90,000	90,000
Matagorda County 1985 series, 10%, due 2015	115,000	115,000
Brazos River 1984 F series, Floating Rate, due 2016	68,700	68,700
Brazos River 1984 A-E series, Floating Rate, due 2019	400,000	400,000
Matagorda County 1984 A-C series, Floating Rate, due 2019	250,000	250,000
Funds on deposit with Trustee	(74,126)	(167,110)
Total pollution control revenue bonds	1,156,674	1,063,690
Unamortized premium or (discount)-net	(4,427)	(5,611)
Capitalized lease obligations, average discount rate 13.8%	1,181	4,353
Total	2,845,877	2,908,277
Utility Fuels, Inc.:		
9% secured notes, due 1988	3,800	11,000
Variable rate notes, due 1988	50,000	50,000
Other	7,472	6,968
Capitalized lease obligations, average discount rate 7 3/4%	30,469	32,776
Total	91,741	100,744
Total	2,937,618	3,009,021
Less current maturities	57,703	52,767
Total long-term debt of subsidiaries	$2,879,915	$2,956,254

See Notes to Consolidated Financial Statements.

	Year Ended December 31,		
(Thousands of Dollars)	1987	1986	1985
Sources of Funds:			
Operations:			
Net income	$ 434,958	$424,935	$ 434,126
Items not requiring current outlay of working capital:			
Depreciation, depletion and amortization	296,068	309,428	264,487
Losses from equity investments	11,039	10,213	
Deferred federal income taxes–net	123,505	161,561	133,868
Investment tax credit deferred–net	(3,472)	24,470	53,285
Allowance for funds used during construction	(252,744)	(279,717)	(258,819)
Total	609,354	650,890	626,947
Common stock dividends	(332,458)	(307,747)	(273,132)
Reinvested funds from operations	276,896	343,143	353,815
Financing:			
Sale of common stock	128,248	176,847	229,215
Sale of preferred stock	99,125		49,021
Sale of first mortgage bonds			200,000
Proceeds from pollution control revenue bonds and first mortgage bonds held in trust	127,874	238,503	275,258
First mortgage bonds issued in exchange offer	390,519		
Sale of debentures and other debt		200,000	8,027
Change in notes payable and temporary cash investments	518,428	95,220	(71,004)
Total financing	1,264,194	710,570	690,517
Other:			
Decrease (increase) in working capital (exclusive of notes payable and temporary cash investments)	(140,770)	(89,573)	118,184
Reclassification to current maturity of long-term debt	(57,703)	(52,767)	(44,193)
Proceeds from settlement of litigation			177,439
Other–net	(50,324)	4,957	(64,340)
Total other	(248,797)	(137,383)	187,090
Total	$1,292,293	$916,330	$1,231,422
Application of Funds:			
Construction and nuclear fuel expenditures (net of allowance for funds used during construction)	$ 662,054	$755,273	$ 893,053
Oil and gas additions	41,488	16,187	224,150
Cable television investment	58,336	26,046	
Reacquired long-term debt	530,415	118,824	114,219
Total	$1,292,293	$916,330	$1,231,422

STATEMENTS OF CHANGES IN CONSOLIDATED FINANCIAL POSITION
(Continued)

(Thousands of Dollars)	Year Ended December 31, 1987	1986	1985
Changes in Components of Working Capital (exclusive of notes payable and temporary cash investments)			
Increase (decrease) in current assets:			
Cash	$ 446	$ (11,460)	$ 702
Accounts receivable	14,872	(16,279)	(14,933)
Inventory	30,364	20,281	(41,992)
Other	(37,809)	32,205	6,375
Total	7,873	24,747	(49,848)
Increase (decrease) in current liabilities:			
Accounts payable	(11,910)	5,595	(34,057)
Taxes and interest accrued	(22,383)	(8,555)	26,849
Current portion of long-term debt	4,936	8,574	(34,500)
Fuel cost over recovery	(94,309)	(62,290)	95,831
Other	(9,231)	(8,150)	14,213
Total	(132,897)	(64,826)	68,336
Increase (Decrease) in Working Capital (exclusive of notes payable and temporary cash investments)	$ 140,770	$ 89,573	$ (118,184)

See Notes to Consolidated Financial Statements.

For the Three Years Ended December 31, 1987

1. Summary of Significant Accounting Policies

System of Accounts

The accounting records of Houston Lighting & Power Company (HL&P), the Company's principal subsidiary, are maintained in accordance with the Federal Energy Regulatory Commission's Uniform System of Accounts which has been adopted by the Public Utility Commission of Texas (Utility Commission).

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, HL&P, Primary Fuels, Inc. (Primary Fuels), Utility Fuels, Inc. (Utility Fuels), Innovative Controls, Inc., KBLCOM Incorporated (KBLCOM), Houston Industries Finance, Inc. (Houston Industries Finance) and Development Ventures, Inc.

Fuel sales and related cost of fuel sold generally represent Utility Fuels' coal and lignite sales to HL&P and are not eliminated because of the distinction for regulatory purposes between utility and non-utility operations. For this same reason, the purchases of accounts receivable from HL&P by Houston Industries Finance also are not eliminated. All other significant intercompany transactions and balances are eliminated in consolidation. Investments in affiliates in which the Company has a 20% to 50% interest are recorded using the equity method of accounting.

The Company adopted Statement of Financial Accounting Standards (SFAS) No. 94, "Consolidation of All Majority-Owned Subsidiaries," in the fourth quarter of 1987. As a result, the accounts of Houston Industries Finance, a wholly-owned finance subsidiary, are included in the Company's consolidated financial statements for the first time. During the first three quarters of 1987, Houston Industries Finance was presented as an unconsolidated subsidiary accounted for under the equity method.

Plant

Additions to electric plant, betterments to existing property and replacements of units of property are capitalized at cost. Cost includes the original cost of contracted services, direct labor and material, indirect charges for engineering supervision and similar overhead items and an allowance for funds used during construction (AFUDC). Customer advances for construction reduce additions to electric plant.

Maintenance of property and replacements and renewals of items determined to be less than units of property are charged to expense. The actual or average book cost of units of property replaced or renewed is removed from plant and such cost, plus removal cost less salvage, is charged to accumulated depreciation.

The Company computes depreciation for its non-oil and gas properties using the straight-line method. The depreciation provision as a percentage of the depreciable cost of plant was 3.6% for 1987, 3.7% for 1986, and 3.8% for 1985.

Oil and Gas Property

The Company follows the successful efforts method of accounting for costs incurred in the exploration and development of oil and gas reserves. Lease acquisition costs are initially capitalized and are periodically assessed for impairment of value, and a loss is recognized when appropriate. Intangible development costs applicable to productive wells and to development dry holes and tangible equipment costs related to the development of oil and gas reserves are capitalized. Exploratory costs, including geological costs, costs of dry hole exploratory wells and lease rentals, are expensed as incurred. Producing oil and gas leases are depleted on the unit-of-production method over the estimated proved reserves of the field. Related tangible and intangible costs are depreciated or amortized on the unit-of-production method over the estimated proved developed reserves.

The Company recognizes impairment of its producing properties when the net capitalized costs exceed the estimated realizable value determined on a field-by-field basis.

Allowance for Funds Used During Construction

HL&P accrues AFUDC on construction projects and nuclear fuel payments except for amounts included in the rate base by regulatory authorities. AFUDC was computed using a gross rate of 10.75% beginning in 1987 due to changes caused by the Tax Reform Act of 1986, which generally eliminates a current tax deduction for interest during construction. This gross rate is applicable to all property except certain transition property, principally the South Texas Project Electric Generating Station (South Texas project), on which interest will be permitted as a current deduction. The net-of-tax accrual rate was 9% during 1987, and such rate was 10% during 1986 and 1985.

Revenues–Electric

Revenues are recognized from the sale of electricity as bills are rendered to customers. The Utility Commission provides for the recovery of fuel and the energy portion of purchased power costs through an energy component of base electric rates. The energy component is established during a utility's general rate proceeding and is effective for a minimum of twelve months. The rules provide for a reconciliation of fuel revenues, with any over- or under-recovery of fuel costs to be considered in establishing future fuel cost recoveries. In February 1986, the Utility Commission adopted a rule that requires a monthly reduction of the fuel factor if the Utility Commission determines that a utility has materially over-recovered, or projects that it will over-recover allowable fuel costs under its existing fuel factor. The rule also provides for any fuel cost savings to be refunded as a one-time credit to customers' bills.

Federal Income Taxes

The Company follows a policy of comprehensive interperiod income tax allocation. The Tax Reform Act of 1986 eliminated investment tax credits effective January 1, 1986, except with respect to certain transition properties, principally the South Texas project. Investment tax credits are deferred and amortized over the estimated lives of the related property.

Earnings Per Common Share

Earnings per common share are computed by dividing net income by the weighted average number of shares outstanding during the respective periods.

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2. Common Stock

Common stock issued during 1987, 1986 and 1985 amounted to 3,536,617 shares, 5,598,652 shares and 9,063,738 shares, respectively.

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3. Preferred Stock

HL&P's preferred stock may be redeemed at the following per share prices, plus any unpaid accrued dividends to the date of redemption:

Not subject to mandatory redemption:

$4.00 Series: $105.00.
$6.72 Series: $102.51.
$7.52 Series: $102.35.
$9.52 Series: through September 30, 1990–$105.00; thereafter–$103.00 to $101.00.
$9.08 Series: through March 31, 1991–$103.00; thereafter–$101.00.
$8.12 Series: through November 30, 1992–$104.25; thereafter–$102.25.
$9.04 Series: through January 31, 1989–$105.00; thereafter–$103.00 to $101.00.

Adjustable Rate Series "A": through March 31, 1989–not redeemable; thereafter–$103.00 to $100.00. The dividend rate on this series, as of January 1, 1988, is 7.75%. The rate is adjusted quarterly, based on the yield on U.S. Treasury securities.

Adjustable Rate Series "B": through September 30, 1990–not redeemable; thereafter–$103.00 to $100.00. The dividend rate on this series, as of January 1, 1988, is 7.50%. The rate is adjusted quarterly, based on the yield on U.S. Treasury securities.

Subject to mandatory redemption:

$8.50 Series: through May 31, 1992–$108.50; thereafter–$104.25 to $100.00; provided that the $8.50 Series may not be redeemed, directly or indirectly, prior to June 1, 1992 from the proceeds of any refunding through the incurrence of debt or through the issuance of preferred stock ranking equally with or prior to the \$8.50 Series as to dividends or liquidation, where such debt has an effective interest cost or such preferred stock has an effective dividend cost, of less than [illegible]% per annum. The mandatory redemption provision requires HL&P to redeem 200,000 shares annually beginning June 1, 1993.

4. Long-Term Debt

At December 31, 1987, sinking or improvement fund requirements of HL&P's first mortgage bonds outstanding will be approximately \$36 million for each of the years 1988 through 1992. Of such requirements, approximately \$17 million for each of the years 1988 through 1992 may be satisfied by certification of property additions at 100% of the requirements, and the remainder through certification of such property additions at 166⅔% of the requirements. Sinking or improvement fund requirements for 1987 and prior years have been satisfied by certification of property additions.

HL&P has agreed to expend an amount each year for replacements and improvements in respect of its depreciable mortgaged utility property equal to \$1,450,000 plus 2½% of net additions to such mortgaged property made after March 31, 1948, and before July 1 of the preceding year. Such requirement may be met with cash, first mortgage bonds, gross property additions or expenditures for repairs or replacements, or by taking credit for property additions at 100% of the requirements. At the option of HL&P, but only with respect to first mortgage bonds of a series subject to special redemption, deposited cash may be used to redeem first mortgage bonds of such series at the applicable special redemption price.

Consolidated annual maturities of long-term debt and minimum capital lease payments are approximately \$58 million in 1988, \$58 million in 1989, \$3 million in 1990, \$5[illegible] million in 1991 and \$81 million in 1992. See also Note 1[illegible].

The issuable amount of HL&P's first mortgage bonds is unlimited as to authorization, but limited by property, earnings, and other provisions of the Mortgage and Deed of Trust and the supplemental indentures thereto. Substantially all properties of HL&P are subject to liens securing its long-term debt.

5. Short-Term Financing

The interim financing requirements of the Company's operating subsidiaries are met through short-term bank loans, the issuance of commercial paper and short-term advances from the Company. The Company and its subsidiaries had bank lines of credit aggregating \$1.350 billion and \$1.050 billion at December 31, 1987 and 1986, respectively, which limit its total short-term borrowings and provide for interest at rates generally less than the prime rate. Bank loans and commercial paper outstanding were \$6,000,000 and \$718,609,000, respectively, at December 31, 1987 and \$50,000,000 and \$169,011,000, respectively, at December 31, 1986. Commitment fees are required on the undrawn portion of the lines.

6. Retirement Plan

In 1986, the Company adopted SFAS No. 87, "Employers' Accounting for Pensions," for its retirement plan, retroactive to January 1, 1986. Pension costs for 1987 and 1986, and related disclosures as of December 31, 1987 and 1986, are determined under the provisions of SFAS No. 87. Pension costs for the plan in 1985 are determined under the provisions of [illegible] accounting principles.

The Company has a noncontributory retirement plan [illegible] substantially all employees. The plan provides retirement benefits based on years of service and the employee's highest 36 consecutive months' base compensation during the last 120 months of employment. The policy of the Company is to fund all net pension costs, but past service costs only to the extent that the excess of plan assets over accrued benefits does not meet the Company's funding obligations for past service costs. In 1987 and 1986, however, as a result of the change in federal income tax rates and HL&P's early retirement program, discussed below, the Company funded the maximum amount deductible for federal income tax purposes. Plan assets consist principally of common stocks and investments in short-term, high quality, interest-bearing obligations.

In January 1987, HL&P offered employees (excluding officers) who were 55 years of age and had 15 years of service as of February 28, 1987 an incentive program to retire early. For employees electing early retirement, the program would add three years of service credit and three years in age up to 35 years of service and age 65, respectively, in determining an employee's pension. Each participating employee would also receive a supplemental benefit to age [illegible] (or a minimum of two years). The early retirement incentive was accepted by 43[illegible] empl[illegible].

Pension benefits are being paid out of the Company's retirement plan assets and the supplemental benefits are being paid by HL&P. Upon the adoption of the early retirement plan, the projected benefit obligations pertaining to the Company's retirement plan and supplemental benefits were increased by

$17.5 million and $7.2 million, respectively. HL&P has deferred the costs associated with the increases in these projected benefit obligations and will request recovery through electric rates in its next rate proceeding before regulatory authorities. At December 31, 1987, HL&P's obligation related to the supplemental benefits was $5.8 million.

Net pension cost includes the following components:

	Year Ended December 31,	
(Thousands of Dollars)	1987	1986
Service cost–benefits earned during the period	$ 13,536	$ 11,254
Interest cost on projected benefit obligation	23,096	18,202
Return on plan assets–actual	(10,359)	(26,666)
–deferred gain (loss)	(10,257)	9,128
Amortization of transitional asset and prior service cost	(1,474)	(1,924)
Net pension cost	$ 14,542	$ 9,994

The funded status of the retirement plan was as follows:

	December 31,	
(Thousands of Dollars)	1987	1986
Actuarial present value of:		
Vested benefit obligation	$182,097	$140,468
Accumulated benefit obligation	$210,849	$169,494
Plan assets at market value	$254,211	$237,702
Projected benefit obligation	279,860	237,643
Assets in excess of (less than) projected benefit obligation	(25,649)	59
Unrecognized transitional asset at January 1, 1986	(28,779)	(30,703)
Unrecognized prior service cost	6,220	
Unrecognized net loss	16,174	11,598
Accrued pension cost at December 31	$ (32,034)	$ (19,046)

The projected benefit obligation was determined using an assumed discount rate of 9½% in 1987 and 8½% in 1986 and an assumed long-term rate of compensation increase of 6½% in both years. The assumed long-term rate of return on plan assets is 9%. The transitional asset at January 1, 1986 is being recognized over approximately 17 years, and the prior service cost is being recognized over approximately 15 years.

The total pension cost of the Company's retirement plan for 1985 was $14,649,000.

7. Commitments and Contingencies

Significant commitments have been incurred in connection with HL&P's construction program and for nuclear fuel purchases. The construction program (exclusive of AFUDC) is presently estimated to cost $477 million in 1988, $431 million in 1989 and $349 million in 1990. These amounts do not include expenditures on projects for which HL&P expects to be reimbursed by customers or cogenerators and also do not reflect the possible acquisition by HL&P of an additional 16% interest in the South Texas project. See Note 10 for discussions of such possible acquisition and the revised budget and schedule for the South Texas project. An additional $50 million is expected to be spent during such period for uranium concentrate and nuclear fuel processing services for HL&P's portion of the South Texas project. Commitments in connection with HL&P's construction program, principally for generating plants and related facilities, are generally revocable by HL&P subject to reimbursement to manufacturers for expenditures incurred or other cancellation penalties. In addition, during the 1988-1990 period, Utility Fuels expects to spend $127 million for coal and lignite supply related equipment, of which $57 million is expected to be spent in 1988, $46 million in 1989, and $24 million in 1990. Primary Fuels expects to spend approximately $57 million on oil and gas exploration and development during 1988.

8. Pending Litigation

Appeal of 1982 Rate Order.

On December 16, 1987, the Texas Supreme Court rendered its decision on an Application for Writ of Error filed by the Utility Commission in connection with a December 1982 rate order by the Utility Commission (Docket No. 4540). In the rate order, the Utility Commission disallowed the recovery by HL&P of approximately $166 million of costs incurred in connection with its cancelled Allens Creek nuclear project, and ordered that any tax savings associated with the disallowed portion be passed through to customers. While the Utility Commission purported to permit $195 million of expenditures for the project to be recovered over a ten-year period, the flow-through of tax savings on the disallowed portion reduced the recovery to approximately $84 million. That decision was appealed by HL&P to the 201st Judicial District Court in Travis County, Texas which ruled, in December 1984, that the Utility Commission was without legal authority in imposing such punitive measures. The District Court ruled that, since the Utility Commission had found that the shareholders, and not the ratepayers, should bear the disallowed Allens Creek expenditures, the shareholders should receive any and all tax benefits associated with those expenditures. The rate order had also reduced a recommended return on common equity from 16.85% to 16.35% as "a penalty for poor management," based principally on findings that HL&P had been imprudent in the handling of its nuclear construction projects. The District Court ruled that the Utility Commission had no statutory authority for such a penalty, and that the Utility Commission's findings regarding HL&P's management of the South Texas project were "premature and presumptuous" in view of the then pending litigation on such issues against the former architect-engineer. The District Court also ruled that the 1982 rate order had erroneously and prematurely attempted to exclude from HL&P's cost of service any of its expenses in connection with the litigation, as well as any amounts which may ultimately be assessed against HL&P in such litigation. Based on such rulings, the District Court remanded the case to the Utility Commission for further proceedings consistent with the final judgment. The Utility Commission appealed the District Court's decision to the Court of Appeals for the Third Supreme Judicial District of Texas, which essentially upheld the District Court in an opinion issued April 9, 1986 (which was modified and reissued on July 2, 1986). The Texas Supreme Court granted the Utility Commission application for Writ of Error to consider certain points of error raised by the Utility Commission, as well as certain other points raised by HL&P.

Although the Texas Supreme Court affirmed certain aspects of the lower courts' decisions, including a ruling to the effect that the Utility Commission had no statutory authority to impose a penalty on HL&P's rate of return, that court reversed the lower courts' decisions regarding allocation of certain income tax benefits associated with the disallowed costs to the benefit of shareholders and held that such income tax benefits should inure to the benefit of HL&P's ratepayers.

HL&P has filed a motion for rehearing on the issue reversed by the Texas Supreme Court. The Utility Commission has also sought rehearing on the issues affirmed by that court. Action on those motions is currently pending before the Texas Supreme Court. As a result of the Texas Supreme Court's affirmation of certain of the lower courts' decisions, the case is to be remanded to the Utility Commission for determination and implementation subject to pending motions for rehearing and possible further appeals by HL&P. Previously reported financial results will not require restatement.

Jury Award in Condemnation Proceeding.

In July 1981, HL&P filed a condemnation action against the Klein Independent School District (Klein) to take approximately 8.6 acres of Klein's property as an easement for the purpose of erecting, operating and maintaining a 345-kilovolt electric transmission line. Klein subsequently alleged in the County Civil Court at Law No. 1 of Harris County, Texas that HL&P had abused its discretion in the taking of the property. On November 27, 1985, the jury returned a verdict finding that Klein sustained actual damages of approximately $104,000. The jury also found that HL&P's conduct in the construction, operation and maintenance of the transmission line on Klein's property was in reckless disregard of the school purposes for which the property was being used, and awarded exemplary damages in the amount of $25 million. The jury found, further, that the value of Klein's property had been reduced to zero and that the cost of land and facilities necessary to replace or restore Klein's property and facilities was approximately $42.1 million. On December 13, 1985, the trial judge entered judgment in favor of Klein, awarding the full amounts of actual and punitive damages, or a total of approximately $25.1 million, plus interest, Klein having elected that form of judgment rather than a judgment awarding condemnation damages. In addition, the court granted an injunction, pending appeal, that effectively prohibited HL&P from using

8. Pending Litigation (continued)

the line for the transmission of energy, except during certain specified emergencies when there are no regularly conducted school or other publicly sponsored activities occurring on Klein's property.

On January 2, 1986, HL&P appealed the case to the Court of Appeals for the 14th Supreme Judicial District of Texas, and also sought, from that court, relief from the injunction against use of the line pending appeal or, in the alternative, an order increasing the bond which Klein must file in order to protect the interests of HL&P pending appeal. On February 27, 1986, the appellate court granted HL&P's requested relief from the injunction and directed the trial court to allow HL&P to post a bond that would allow continued use of the easement pending a final decision on the merits of HL&P's appeal. Klein responded on March 3, 1986, by asking the Texas Supreme Court for leave to file a mandamus petition against the 14th District Court of Appeals. On November 26, 1986, the Supreme Court conditionally granted the mandamus petition sought by Klein. Ruling that the trial court had not abused its discretion in denying HL&P's request to supersede the injunction, the Supreme Court indicated that it would grant the writ of mandamus if the Court of Appeals did not vacate its judgment, with the result of that decision being the reinstatement of the trial court's original order, which had enjoined HL&P from using the line pending the outcome of the appeal on the merits. In light of the injunction that effectively prohibited use of the line, HL&P placed a rerouted line in service in August 1987.

On November 5, 1987, the 14th District Court of Appeals issued its decision on the merits of the appeal by HL&P. The court ruled that HL&P's action pursuant to the statutory condemnation procedure could not amount to trespass and set aside the award of exemplary damages to Klein, thus relieving HL&P from liability for the $25 million in exemplary damages awarded by the trial court. The appeals court affirmed the trial court judgment on the balance of the points raised in the appeal, leaving intact the jury's award of approximately $104,000 in actual damages. The appeals court noted, however, that HL&P had rerouted the transmission line away from Klein's property.

Klein has filed an Application for Writ of Error with the Texas Supreme Court seeking further review of the appeals court's decision. HL&P has filed a contingent Application for Writ of Error to be considered in the event that the Texas Supreme Court grants Klein's Application. It is possible that the exemplary damages awarded by the trial court might be reinstated if the Supreme Court agrees to hear a further appeal of the decision. While HL&P and the Company can give no definitive assurance regarding the ultimate resolution of this matter, they presently do not believe such resolution will have a material adverse impact on HL&P's or the Company's financial position. No prediction can be made, however, of the final outcome or the timing of final judicial action in this suit.

Prudence Review of Coal Supply Agreements and Litigation with Coal Suppliers.

During the course of hearing HL&P's 1986 general rate proceeding (Docket No. 6765), the Utility Commission severed into a separate docket (Docket No. 6963) certain issues related to the prudence of the two long-term contracts under which substantially all of the coal for HL&P's W. A. Parish generating units is obtained, including the degree to which the chemical characteristics of coal from one of those suppliers led to HL&P's decision to upgrade existing pollution control equipment by installing baghouses on three of those generating units. The Utility Commission staff requested that, pending the outcome of the separate docket, HL&P be at risk for all costs associated with the installation of the baghouses (estimated to total $178 million excluding AFUDC) and for payments made for coal in excess of the equivalent of a delivered price of $1.51 per million Btu's.

As a result of the Utility Commission's action, the Company, HL&P and Utility Fuels filed suit against the two coal suppliers in question in the United States District Court for the Northern District of Texas in Dallas. In that lawsuit, the plaintiffs requested the court to determine that performance under the contracts should be suspended or the contracts modified in the event the Utility Commission should proceed to a final determination that the maximum cost that can be included in electric rates charged to HL&P's customers is less than the amounts called for under the contracts. In addition, Utility Fuels began withholding from payments to the coal suppliers the difference between the amounts called for in the contracts and the equivalent of a delivered price of $1.51 per million Btu's and sought to deposit that difference into the registry of the Court. In response, both coal suppliers filed counterclaims and motions for partial summary judgment on those counterclaims. On November 18, 1986, the trial court granted those motions for summary judgment in part, ruling that HL&P and Utility Fuels must pay the full contract price for coal pending the outcome of the Utility Commission proceeding and directing that the amounts previously withheld be paid to the coal companies with interest.

8. Pending Litigation (continued)

The Company, HL&P and Utility Fuels appealed the trial court's decision to the Fifth Circuit Court of Appeals and continued to withhold the amounts in dispute pending the outcome of the appeal. On October 7, 1987, the Fifth Circuit Court of Appeals ruled that the trial court's decision was not a final, appealable order and therefore dismissed the appeal without considering the issues raised therein.

On April 20, 1987, a Utility Commission Hearings Examiner granted a motion by HL&P to suspend the procedural dates then in effect in Docket No. 6963 in order to allow Utility Fuels, HL&P and the coal companies to continue negotiations of certain modifications to the coal supply arrangements in an attempt to provide the basis for resolution of the issues in Docket No. 6963. Those negotiations were concluded on December 21, 1987, when amendments to both coal supply contracts in question were executed. Under the amended contracts, the price paid by Utility Fuels was reduced as of January 1, 1988, and changes were made in the escalation and certain other provisions of the contracts. At the time the amended contracts were executed, Utility Fuels, pursuant to an agreed court order, paid the coal suppliers the amounts which previously had been withheld, including interest thereon.

In January 1988, HL&P and the Utility Commission staff filed testimony proposing that the amended coal supply arrangements be accepted by the Utility Commission in resolution of the issues raised in Docket No. 6963. HL&P also filed an agreed stipulation executed by HL&P, the staff and one other party to the docket. Under the stipulation, the new coal supply arrangements would be accepted by the Utility Commission and issues raised in the docket with respect to (i) prudence of amounts incurred prior to January 1, 1988 and (ii) the relationship of coal quality to the decision to install baghouses would be resolved without disallowance of amounts paid by HL&P for prior coal deliveries. However, in March 1988, the Utility Commission Hearings Examiner considering the docket issued a recommended decision in which he urged the Utility Commission to remand the matter for further evidentiary proceedings on certain points in the proposed stipulation which were questioned by the Hearings Examiner. Rather than reopening the record on his own motion, the Hearings Examiner chose to present his concerns to the Utility Commission for ruling prior to remand. A decision by the Utility Commission on the Hearings Examiner's recommendations is expected at the end of March 1988. In the event that the outstanding coal prudence issues are not resolved by the Utility Commission on a mutually acceptable basis, the parties to the new coal supply arrangements have reserved the right to terminate those arrangements and resume the litigation relating to the previous long-term agreements.

While HL&P and the Company can give no definitive assurance regarding the ultimate resolution of this matter, they presently do not believe that such resolution will have a material adverse impact on HL&P's or the Company's financial position. Should HL&P be unable to recover its costs, such costs may have to be charged against earnings.

Fuel Transportation Litigation.

On July 31, 1986, HL&P and Utility Fuels filed suit in Federal District Court in Houston, Texas against three railroad holding companies and their railroad operating subsidiaries and two other railroads. The suit alleges that the railroads violated certain federal statutes, including the Sherman Act, in activities aimed at precluding development of coal slurry pipelines that could have delivered coal to the plaintiffs in competition with the railroads. On February 13, 1987, with the agreement of all parties, the Federal District Court in Beaumont, Texas entered its order permitting HL&P and Utility Fuels to file the same claims for alleged antitrust violations against the same railroads by intervention in an action there pending between a third party and the same railroads. HL&P and Utility Fuels have joined with the railroads in requesting the Federal District Court in Houston to stay proceedings in the Houston litigation pending the outcome of the Beaumont litigation.

Among the defendants are the Burlington Northern Railroad Company (Burlington Northern) and the Atchison, Topeka and Santa Fe Railway Company (ATSF), which supply rail transportation services to Utility Fuels for coal purchased from mines in the Powder River Basin in Montana and Wyoming. In the litigation, Burlington Northern and ATSF have filed counterclaims based on the assertion that certain of the matters alleged to be in dispute in the litigation filed by Utility Fuels and HL&P were settled as a result of the execution of the Rail Transportation Agreement, dated March 8, 1985, among Utility Fuels and Burlington Northern and ATSF. Accordingly, the counterclaims assert that Utility Fuels is in breach of its obligation under the Rail Transportation Agreement by virtue of the filing of suit against Burlington Northern and ATSF.

In their counterclaims Burlington Northern and ATSF seek unspecified damages, including punitive damages. Utility Fuels and HL&P regard the counterclaims to be without merit, but no assessment of the ultimate outcome of the litigation can be made at this time. See also Note 10–Jointly-Owned Nuclear Plant.

9. Limestone Generating Units

In December 1986, the second of two 720 megawatt, lignite-fired generating units at HL&P's Limestone Electric Generating Station (Limestone) was placed into commercial operation. In January 1987, HL&P requested that the Utility Commission order an accounting treatment which would permit HL&P to capitalize operating and maintenance expenses, non-reconcilable mining and handling charges, taxes and depreciation associated with Limestone Unit No. 2 and to continue recording AFUDC from the date Unit No. 2 was placed in commercial operation until the date when new rates are implemented that reflect Limestone Unit No. 2 as plant in service in rate base (Docket No. 7375). HL&P further requested, as an alternative, that if the mining and handling charges referred to above are not allowed to be capitalized, then those costs would be allowed recovery through the reconcilable fuel portion of base rates. Hearings in this docket concluded on June 10, 1987, and a decision by the Utility Commission is pending. A similar accounting treatment had been requested by HL&P for Limestone Unit No. 1 but was denied by the Utility Commission. Until rate relief or other regulatory action is taken with respect to Limestone Unit No. 2, operating results of HL&P and the Company will be adversely affected.

10. Jointly-Owned Nuclear Plant

HL&P is project manager and one of four participants in the South Texas project, which consists of two 1,250 megawatt nuclear generating units. Each participant finances its own share of construction expenditures with HL&P's participating interest in the project currently being 30.8%. As of December 31, 1987, HL&P's investments in the South Texas project and in nuclear fuel, including AFUDC, were $2.2 billion and $131 million, respectively.

Pending Litigation and Agreement in Principle with the City of Austin.

In January 1983, the City of Austin (Austin), one of the four owners of the South Texas project, filed suit against HL&P and the Company in the 98th Judicial District Court in Travis County, Texas (Cause No. 343,240), alleging that HL&P had misrepresented the capabilities of the original architect-engineer and construction manager of the project and failed to properly perform its duties as project manager. Because of such alleged misrepresentations and failures, Austin asserted it was entitled to, among other things, (a) a reformation of the participation agreement such that Austin would convey to HL&P its 16% interest in the project, (b) a refund from HL&P of the approximately $437 million expended by Austin to that date, and of all sums expended by Austin on the project thereafter, and (c) damages in an additional unspecified amount. In December 1985, Austin filed an amended petition which again alleged that HL&P had misrepresented the capabilities of the former architect-engineer and failed to properly perform its duties as project manager for the South Texas project. In addition, the amended petition asserted claims against HL&P under the Texas Deceptive Trade Practices--Consumer Protection Act (DTPA) and sought, from HL&P and the Company, either (a) an unspecified amount of damages, including treble damages to the extent proper under the DTPA, as well as pre-judgment interest costs and attorneys' fees, or (b) a reformation or rescission of the participation agreement for the South Texas project requiring HL&P to return to Austin all of the moneys expended by Austin with respect to its 16% interest in the project to the date of the judgment, with interest, relieving Austin of all future obligations with respect to such interest in the project, and providing for a concurrent transfer by Austin of such interest to HL&P.

Austin and HL&P have filed motions for partial summary judgment. On October 10, 1986, the trial judge ruled that Austin is not entitled to reformation or rescission of the participation agreement for the South Texas project. The trial judge overruled HL&P's motion for partial summary judgment directed at Austin's allegations asserting a cause of action under the DTPA and HL&P's motion for partial summary judgment directed at Austin's allegations that there was fraud in the inducement relating to Austin's entry into the participation agreement. On June 29, 1987, a newly appointed trial judge denied Austin's motion seeking to hold HL&P responsible for the actions of the former architect-engineer. The judge denied, however, HL&P's request for summary judgment on all claims relating to the participation agreement. The judge ruled that Austin must prove that HL&P breached the participation agreement by failing to report material information and must prove damages specifically related to such failure to provide information. The judge permitted Austin to maintain its claim for $830 million under this theory of recovery if it could show that the owners would have cancelled the South Texas project in 1976 and that Austin would have built a coal plant in lieu of the South Texas project. However, on August 10, 1987, Austin provided an updated calculation of its alleged damages under that claim, dropping its claim under this theory of recovery to $740 million. On August 11, 1987, the judge reversed the earlier order

10. Jointly-Owned Nuclear Plant (continued)

denying HL&P's motion for summary judgment as to Austin's DTPA claims. Thus, Austin's DTPA claims have been mooted and its damage claims are no longer subject to trebling under the DTPA.

As a result, the maximum damage claim remaining in the case is an alternative claim for $811 million relating to Austin's claim that it was fraudulently induced to enter into the South Texas project in 1973. The judge has not yet acted on HL&P's motion for summary judgment on this issue.

On September 3, 1987, HL&P announced that it had reached an agreement in principle (Agreement in Principle) with Austin to acquire Austin's 16% share of the South Texas project. Under the terms of the Agreement in Principle, HL&P and Austin would dismiss all litigation and other claims currently pending.

The Agreement in Principle provides that Austin would convey to HL&P its 400 megawatt (MW) interest in the South Texas project, together with nuclear fuel and related property, in exchange for a 400 MW interest in HL&P's Limeston[illegible]ation, a lignite plant having a capability of 1,440 MW which has been completed and placed in service. This conveyance would result in Austin having an undivided proportionate interest in the land, capital equipment, and fixed personal property of HL&P at Limestone. A 200 MW interest in Limestone Unit No. 1 would be conveyed on the later of June 1, 1988 or the closing of the settlement, and a 200 MW interest in Limestone Unit No. 2 would be conveyed on January 1, 1990. HL&P would operate Limestone in accordance with an operating agreement to be mutually agreed upon as part of the definitive documentation.

Under the terms of the Agreement in Principle, HL&P would (a) assume Austin's South Texas project obligations for the remaining construction and fuel costs effective September 1, 1987, as well as Austin's obligations for continuing capital improvements, decommissioning, and all other matters arising out of Austin's interest in the South Texas project; (b) pay Austin $19.7 million for a portion of construction costs incurred during negotiations; (c) purchase Austin's nuclear fuel for $30 million; and (d) pay certain of Austin's legal expenses. In addition, certain claims asserted by Austin under an outstanding purchased power contract would be resolved. Austin would assume responsibility for its portion of the capital improvements and fuel, operating and maintenance expenses at Limestone.

The Agreement in Principle provides that no contract obligation will come into existence until execution of the definitive contract documents and other conditions have been satisfied, including approval by the Utility Commission and the Nuclear Regulatory Commission (NRC).

In addition, the Agreement in Principle provides that it would be necessary that the order of the Utility Commission, among other things, contain no findings, conclusions, reservations, or observations by a majority of the Utility Commission that raise reasonable doubt that the transfers contemplated by the Agreement in Principle would result in rate treatment to HL&P less favorable than the rate treatment of HL&P prior to such transfers. In September 1987, HL&P filed an application with the Utility Commission (Docket No. 7725) to reflect the exchange of ownership of Limestone and the South Texas project pursuant to the Agreement in Principle. The settlement is also contingent upon the City of San Antonio (San Antonio) and Central Power and Light Company (CPL), the other participants in the South Texas project, waiving their rights of first refusal relating to acquiring part of Austin's interest.

On January 7, 1988, HL&P filed a Fourth Amended Answer, Original Third Party Petition and Original Petition for Declaratory Relief (Third Party Petition) in the pending litigation with Austin. In the Third Party Petition, HL&P requested leave of the court in which the Austin litigation is pending to make service on San Antonio and CPL and its parent corporation, Central and Southwest Corporation (CSW). The Third Party Petition makes claim against San Antonio, CPL and CSW for contribution and indemnity should HL&P be found to be liable to Austin with respect to certain claims of Austin in the pending litigation. The Third Party Petition asks for a declaratory judgment that HL&P is not liable to Austin, San Antonio, CPL or CSW with respect to its actions or inactions as project manager under the Participation Agreement among the co-owners of the South Texas project and further requests the court in the Austin litigation to implement alternative methods of dispute resolution provided by the Texas Civil Practice and Remedies Act such as non-binding arbitration. Finally, the Third Party Petition asks the court to defer or abate proceedings until completion of the second unit at the South Texas project but no later than December 31, 1990. Unit No. 2 of the South Texas project is presently scheduled for commercial operation in June 1989.

At a hearing on January 27, 1988, the court in the Austin litigation set the pending suit between Austin and HL&P for trial the first week in June 1988. The court in the Austin litigation, which has discretion whether to accept jurisdiction over the claims asserted in the Third Party Petition, allowed HL&P to

10. Jointly-Owned Nuclear Plant (continued)

serve the Third Party Petition on San Antonio, CPL and CSW without prejudice to the right of those parties to later assert that the Third Party Petition should be dismissed or severed for a separate trial in the Austin litigation or severed into a separate docket independent of the Austin litigation. The court also advised the parties that in no event would San Antonio, CPL and CSW be required to participate in the trial of the pending suit between Austin and HL&P. HL&P has also filed an original complaint in the 130th District Court of Matagorda County against San Antonio, CPL and CSW requesting substantially the same relief. If the court in the Austin litigation does not ultimately dismiss the Third Party Petition, prosecution of the action in Matagorda County will be deferred.

On March 3, 1988, San Antonio and CPL filed responses to the Third Party Petition, and each delivered letters requesting arbitration. In their responses and letters, both San Antonio and CPL asserted that HL&P has breached its duties and obligations as project manager for the South Texas project and is liable to San Antonio and CPL for resulting unspecified damages. San Antonio and CPL asked the trial judge in the Austin litigation to compel their requested arbitration and to stay further proceedings with respect to CPL and San Antonio pending the outcome of that arbitration. They further asked the trial court to enjoin HL&P from pursuing either its Third Party Petition or the separate litigation filed by HL&P in Matagorda County. No hearing has been scheduled by the court in the Austin litigation to consider these matters. CSW also responded to the Third Party Petition on March 3, 1988, asking that further proceedings be deferred pending the arbitration, and denying any liability with respect to the South Texas project.

The parties have continued settlement negotiations within [illegible] work contemplated by the Agreement in Principle; however, no prediction can be made a[illegible]hether a settlement with Austin can be achieved. If a definitive agreement cannot be reached, any judgment entered after trial, as well as the intermediate ruling discussed above, will be subject to appeal after trial. With respect to the pending litigation, HL&P and the Company regard Austin's claims and those asserted by CPL and San Antonio to be without merit. While HL&P and the Company cannot give definitive assurance regarding the ultimate resolution of these matters, they presently do not believe such resolution will have a material adverse impact on HL&P's or the Company's financial position.

Assuming the Agreement in Principle is consummated, HL&P's construction and nuclear fuel expenditures would increase by $205 million for the 1988–1990 period, $92 million of which is related to reimbursement of costs incurred by Austin prior to 1988 and the purchase of Austin's nuclear fuel.

Order of the Texas Supreme Court.

On November 4, 1987, the Texas Supreme Court entered an order which likely will delay the schedule for Docket No. 7725 and certain other dockets pending before the Utility Commission. The Court's order directed the Commissioners of the Utility Commission to stay hearings and actions in Docket No. 7725 and certain other dockets pending disposition by the Court of a Motion filed by the Attorney General of Texas for Leave to File Petition for Writ of Mandamus against the Commissioners. In addition to Docket No. 7725, the Court's order applies to Docket No. 6184, an inquiry concerning the economic viability of Unit No. 2 of the South Texas project, and Docket No. 7582, in which HL&P petitioned for deferred accounting treatment for costs related to Unit No. 1 of the South Texas project. The mandamus petition arose from action by the Utility Commission in these and certain other dockets denying the Attorney General's petitions to intervene on behalf of the Texas state agencies.

HL&P and the Company cannot be certain at this time as to the duration of the Texas Supreme Court's stay or as to the effect of the Court's action on these dockets. A hearing by the Court on the Attorney General's petition was held on December 16, 1987, and the Writ of Mandamus will remain in effect until the Texas Supreme Court resolves this issue.

Prudence Review of South Texas Project by Utility Commission.

The Utility Commission has instituted a prudence review of the South Texas project for the purpose of reaching a final and binding determination for future rate base treatment of the amounts invested in the South Texas project. This proceeding (Docket No. 6668) will encompass an investigation of the prudence and efficiency of the planning, management and construction of the South Texas project, as well as the proper accounting treatment of the proceeds received from the former architect-engineer in the settlement (Settlement) of certain litigation relating to the South Texas project. There is no definitive schedule for commencement of hearings, but it is unlikely that hearings will begin before the fall of 1988.

10. Jointly-Owned Nuclear Plant (continued)

The Utility Commission retained a consulting firm to evaluate the prudence and efficiency of the planning and management of the South Texas project and to make recommendations to the Utility Commission regarding regulatory actions based on such evaluation. In June 1986, the consulting firm presented its report (Report) to the Utility Commission, which Report covered the period through 1983. The consulting firm concluded in the Report that deficiencies in management of the project had occurred and that such deficiencies led to imprudent expenditures estimated to be in a range of $1.1 to $1.3 billion. According to the Report, such amounts do not include AFUDC or rate effects which the consulting firm concluded would substantially offset each other. The Report also indicated that the estimates relating to the prudence issue were preliminary, were based upon certain assumptions that should be refined and were subject to further refinement and modification.

A new consultant is expected to be retained by the Utility Commission in March 1988 to complete all work necessary for a final evaluation concerning the prudence of management and the reasonableness of costs associated with the South Texas project. Although the scope of that investigation has not been finalized, HL&P anticipates that the Report will not be sponsored by the Utility Commission staff. The manner in which the new consultant or any other party will utilize the Report in that docket, however, remains unclear.

HL&P believes that the Settlement with the former architect-engineer provided full compensation for any imprudent or inefficient planning or management during the period in question. HL&P will strongly contest any recommendation or finding that amounts invested in the South Texas project, after taking into consideration the Settlement, have been a result of inefficiency or imprudence. While no definitive assurance can be given that all amounts invested in the South Texas project will be recoverable by HL&P through electric rates or otherwise, HL&P and the Company presently believe the ultimate resolution of the Utility Commission's prudence review will not have a material adverse effect on HL&P's or the Company's financial position. Any amounts that are not recoverable would have to be charged against earnings. A substantial write-off could adversely affect the Company's ability to finance its capital program and meet other financial obligations.

Request for Deferred Accounting Treatment.
In July 1987, HL&P requested that the Utility Commission order an accounting treatment which would allow HL&P to defer its portion of all operating and maintenance expenses, taxes and depreciation that would otherwise be expensed effective with the commercial operation of Unit No. 1 of the South Texas project and to continue recording AFUDC associated with this investment until rates are placed into effect which would reflect this investment as electric plant in service in rate base (Docket No. 7582).

Because the hearings in Docket No. 6668 relating to the prudence review of the South Texas project are not currently scheduled and are unlikely to begin before the fall of 1988, a significant lag time could occur between the commercial operation date of Unit No. 1 of the South Texas project and implementation of new rates reflecting such facility as plant in service. As a result of such lag time and without the requested accounting treatment referenced above, HL&P's operating results will be adversely affected unless some other mitigative action by the Utility Commission is taken.

In October 1987, HL&P filed supplemental testimony in response to the issuance of SFAS No. 92. SFAS No. 92 precludes the capitalization of the equity portion of AFUDC for financial reporting purposes as was previously requested in Docket No. 7582. It is anticipated that the effect of such limitation would reduce earnings of the Company by approximately $100 million on an annualized basis. In its supplemental testimony, in lieu of the AFUDC accrual, HL&P requested the accrual of interest on the deferred costs and on the plant investment in Unit No. 1 of the South Texas project. Under this request, HL&P's 1988 financial results would be similar to those under the original deferral request.

Revised Budget and Schedule.
On September 17, 1987, HL&P presented a completion estimate for the South Texas project to the management committee for the project, which estimate was adopted by the committee on December 17, 1987. Based upon its September 1987 completion assessment (which assumed a commercial operation date for Unit No. 1 of March 1, 1988), HL&P estimated that the total cost for the completed project would be $5.28 billion, excluding AFUDC and net of the Settlement. The revised cost estimate represents an increase of $300 million over the previous cost estimate which was $4.98 billion, excluding AFUDC and net of the Settlement, for the entire South Texas project. HL&P's portion of such increased costs would be approximately $92 million based on its current 30.8% interest in the South Texas project.

10. Jointly-Owned Nuclear Plant (continued)

In August 1987, the NRC granted a low power operating license for Unit No. 1 of the South Texas project. In 1987, the Government Accountability Project (GAP), a citizens interest group, demanded that the NRC establish a special task force to investigate alleged safety defects at the South Texas project. The group claimed to have evidence of defects but refused to turn over the evidence until late in 1987. The NRC concluded an on-site investigation to review and evaluate the GAP allegations. The NRC review of all the GAP allegations has identified no substantive safety issues that would warrant delay in the NRC's consideration of a full power license for Unit No. 1 of the South Texas project. In February 1988, the NRC imposed a civil penalty in the amount of $75,000 for two instances in late 1987 when operations during testing at the South Texas project violated certain technical specifications. In March 1988, the NRC imposed a second civil penalty in the amount of $50,000 for security deficiencies indentified in the fall of 1987.

Initial criticality at Unit No. 1 of the South Texas project was achieved in March 1988. The delay in achieving initial criticality has been principally attributable to certain equipment problems identified during the testing process, which have been analyzed and corrected, and the need for additional operator training undertaken to address concerns raised by the NRC. The steps remaining before Unit No. 1 can be placed into commercial operation are satisfactory completion of low power operation and the receipt of a full power license from the NRC.

The in-service date and cost estimate for Unit No. 1 of the South Texas project are subject to continuing review in light of these matters and the ongoing testing process. HL&P estimates that three to five months of additional testing will be required after initial criticality before Unit No. 1 can be placed in commercial operation. Although no definitive estimate of additional costs has been approved, HL&P anticipates that cost increases in the range of $100 to $150 million (of which HL&P's portion would be $31 to $46 million based on its 30.8% interest) may result from the delays in achieving initial criticality and the resulting delay in the anticipated date of commercial operation of Unit No. 1. HL&P estimates that the carrying cost of its 30.8% interest in the South Texas project is approximately $15 million per month.

Commercial operation of Unit No. 2 of the South Texas project is scheduled to commence in June 1989.

Nuclear Insurance.
HL&P and the other owners of the South Texas project have obtained all nuclear property and nuclear liability insurance required to date, and additional insurance coverage will be purchased when the full power license for Unit No. 1 is obtained. In addition, HL&P is evaluating insurance coverage for incremental replacement power costs resulting from certain possible outages at the South Texas project. However, there can be no assurance that all potential losses or liabilities will be insurable or that the amount of insurance carried will be sufficient to cover all potential losses and liabilities. Any substantial losses not covered by insurance could have a material adverse effect on the financial condition of HL&P and the Company.

The owners of the South Texas project currently maintain property damage insurance in the amount of $1.23 billion through American Nuclear Insurers (ANI) and Nuclear Electric Insurance Limited (NEIL) and are planning to purchase an additional $165 million in limits from NEIL when the full power license for Unit No. 1 is obtained. The owners are also considering the purchase of an additional $130 million in limits which has recently become available from ANI. The NEIL excess property damage insurance must be used to cover decontamination and clean-up expenses before being used to cover direct losses to property. Although there can be no assurance as to the maximum amount of property insurance available from time to time, it is anticipated that property insurance coverage will be maintained for the South Texas project in such amounts as are customary in the industry for similar nuclear generating plants. As a member insured of NEIL, HL&P will become subject to annual assessments, which could amount to approximately $9 million for the project, in the event that losses as a result of an accident at a nuclear plant of any NEIL insured company exceed the accumulated funds available to the insurer. HL&P and the other owners of the South Texas project have entered into an arrangement such that the total costs of insurance for the South Texas project (including premiums and assessments) are to be shared pro rata based upon the owners' respective ownership interests in the project. Under this arrangement, HL&P would ultimately bear that portion of total property damage insurance costs, including any assessment by NEIL, attributable to its ownership interest (currently 30.8%).

Effective in October 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. These 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 or safety. Any property insurance proceeds not already expended to place the reactor in a safe and stable condition must be used first to complete decontamination operations that may be ordered by the NRC.

The owners of the South Texas project are insured against liability claims that may result from a nuclear incident to the full amount to which such claims are limited under the Price-Anderson Act (which is $720 million as of January 18, 1988). In January 1987, HL&P and the other owners of the South Texas project executed with the NRC an indemnification agreement under the provisions of the Price-Anderson Act. This limitation on liability will increase by $5 million for each additional operating license issued by the NRC. This insurance is provided through a combination of private insurance and a mandatory industry-wide program of self-insurance under which licensees may be assessed in the event of a nuclear incident involving any licensed facility in the United States up to $5 million per incident for each of its licensed reactors and up to a maximum per reactor owned of $10 million in any calendar year. HL&P and each of the other owners are subject to such assessments, which HL&P and such owners have agreed will be borne on the basis of their respective ownership interests in the project. For purposes of such assessment, the South Texas project currently has one licensed reactor. When fuel loading begins at Unit No. 2, which is expected in December 1988, the South Texas project will have two licensed reactors.

Various proposals have been made to amend the Price-Anderson Act including amendments which would increase the limit on liability. If enacted, such amendments could result in an increase in assessments or other charges to fund the resulting increased coverage. HL&P is unable to predict what action Congress might take regarding the Price-Anderson Act or what effect such actions might have on HL&P.

11. Modified Schedule for Malakoff Project

In January 1987, HL&P announced that the schedule for the construction of two 645 megawatt lignite units at the proposed Malakoff Electric Generating Station in Henderson County, Texas (the Malakoff project) had been modified. The scheduled in-service dates, which are the dates the units are expected to be available to meet peak demand, are now 1997 for Unit No. 1 and 1999 for Unit No. 2. The modified schedule resulted from lowered projections of future demand for electricity in the Houston area. As a result of the modified schedule, all developmental work on the two lignite units has stopped, but HL&P will resume activity when necessary to meet load growth requirements. HL&P's total investment in the Malakoff project, through December 31, 1987, is $154 million including AFUDC and land. This amount is included in Plant Held for Future Use and the accrual of AFUDC has been suspended until such time as construction resumes. HL&P has agreed to indemnify Utility Fuels for all necessary and actual costs incurred due to the modification of the schedule. Utility Fuels has invested $121 million in lignite reserves and handling systems relating to the Malakoff project through December 31, 1987 and suspended capitalization of interest effective December 31, 1986. For the 1988–1990 period, Utility Fuels anticipates $22 million of expenditures relating to the Malakoff project which are primarily associated with keeping lignite leases and other related agreements in effect.

12. Unrecovered Costs

The Utility Commission has allowed recovery of certain costs over a period of time by amortizing those costs for rate making purposes. However, unrecovered amounts have not been included in rate base and, as a result, no return on investment is being earned during the recovery period. The amounts of such assets and the remaining recovery period applicable to each are listed below:

(Thousands of Dollars)	Unrecovered Amount at December 31, 1987	Remaining Recovery Period at December 31, 1987
Allens Creek Project	$36,129	60 months
Other	4,525	11-106 months

13. Federal Income Taxes

The current and deferred components of tax expenses are as follows:

(Thousands of Dollars)		Year Ended December 31, 1987	1986	1985
Current:	U. S.	$ 93,607	$ 23,387	$ 52,259
	Foreign	4,703	2,781	2,572
Deferred:	Liberalized depreciation	79,894	88,441	85,472
	Applicable to AFUDC	40,263	50,310	47,842
	Investment tax credit–net	(3,472)	28,174	51,495
	Oil and gas	695	(6,460)	(17,440)
	Other–net	2,652	29,268	17,989
Federal income taxes		$218,342	$215,901	$240,189

Effective federal income tax rates are lower than statutory corporate rates for each year as follows:

(Thousands of Dollars)	Year Ended December 31, 1987	1986	1985
Income before federal income taxes	$653,300	$640,836	$674,315
Preferred dividends of subsidiary	31,406	26,817	26,602
Total	684,706	667,653	700,917
Statutory rate	40%	46%	46%
Federal income taxes at statutory corporate rate	273,882	307,120	322,422
Reduction in taxes resulting from:			
AFUDC–other included in income	57,434	78,360	70,953
Other–net	(1,894)	12,859	11,280
Total	55,540	91,219	82,233
Federal income taxes	$218,342	$215,901	$240,189
Effective rate	31.9%	32.3%	34.3%

14. Supplementary Expense Information

Taxes, other than federal income taxes, were charged to expense as follows:

(Thousands of Dollars)	Year Ended December 31, 1987	1986	1985
Electric:			
Ad valorem	$ 76,686	$ 73,366	$ 62,806
State gross receipts	35,177	31,630	38,349
Payroll	15,222	18,788	17,712
PUC assessment	4,758	4,709	5,717
Miscellaneous	19,824	18,298	15,601
Total	151,667	146,791	140,185
Taxes included in cost of fuel sold	5,936	4,743	3,193
Taxes included in oil and gas expense	5,475	7,067	8,924
Total	$163,078	$158,601	$152,302
Research and development costs charged to expense	$ 16,141	$ 14,462	$ 14,038

15. Cable Television Joint Venture

KBLCOM owns a 50% interest in Paragon Communications (Paragon), a partnership that owns cable television systems which, as of December 31, 1987, served approximately 651,000 basic cable customers and approximately 469,000 premium programming customers. The remaining interest in the partnership is owned by American Television and Communications Corporation (ATC), a subsidiary of Time, Inc.

In June 1987, Paragon entered into a $430 million revolving credit and letter of credit facility agreement with a group of banks. Borrowings under the agreement are non-recourse to the Company and to ATC. The initial borrowings under the facility were used to provide permanent financing for the acquisition of cable television properties formerly owned by Group W Cable, Inc.

The Company records its investment in Paragon utilizing the equity method of accounting. KBLCOM experienced after-tax losses of $10.6 million and $6.5 million during 1987 and 1986, respectively.

16. Subsequent Events

In January 1988, HL&P sold $400 million aggregate principal amount of 9⅜% first mortgage bonds which will mature in approximately equal principal amounts in each of the years 1991, 1992 and 1993.

In January 1988, HL&P deposited $52 million with the bond trustee to redeem all of the outstanding bonds of the 13⅛% series at 100% of the principal amount and to pay accrued interest. The bonds were redeemed pursuant to the general redemption provisions of HL&P's Mortgage and Deed of Trust.

17. Unaudited Quarterly Information

The following unaudited quarterly financial information includes, in the opinion of management, all adjustments (which comprise only normal recurring accruals) necessary for a fair presentation. Quarterly results are not necessarily indicative of expectations for a full year's operations because of seasonal and other factors, including rate increases and variations in operating expense patterns.

(Thousands of Dollars)	Revenues	Operating Income	Net Income	Earnings per Common Share
March 31, 1986	$ 795,752	$129,627	$ 72,717	$ .67
June 30, 1986	860,429	135,437	78,151	.70
September 30, 1986	1,101,220	326,245	184,845	1.65
December 31, 1986	778,567	135,272	89,222	.79
March 31, 1987	777,250	106,533	57,775	.50
June 30, 1987	899,016	171,136	99,690	.86
September 30, 1987	1,135,680	327,527	203,676	1.75
December 31, 1987	816,267	132,272	73,817	.63

18. Reclassification

Certain amounts from the previous years have been reclassified to conform to the 1987 presentation of financial statements. Such reclassifications do not affect earnings.

AUDITORS' OPINION

Houston Industries Incorporated:

We have examined the consolidated balance sheets and the statements of subsidiaries' preferred stock and long-term debt of Houston Industries Incorporated and subsidiaries as of December 31, 1987 and 1986 and the related statements of consolidated income, consolidated retained earnings and changes in consolidated financial position 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.

In our opinion, the accompanying consolidated financial statements present fairly the financial position of the Company and its subsidiaries at December 31, 1987 and 1986 and the results of their operations and the changes in their financial position 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

Houston, Texas
March 3, 1988

HOUSTON INDUSTRIES INCORPORATED

Officers

Don D. Jordan
55, President and Chief Executive Officer

Hollis R. Dean
62, Executive Vice President and Chief Financial Officer

William A. Cropper
48, Vice President and Treasurer

Robert B. Dyer
51, Vice President Corporate Development

Hugh Rice Kelly
45, Vice President, General Counsel and Corporate Secretary

David M. McClanahan
38, Vice President and Comptroller

Don D. Sykora
57, Vice President

Gretchen H. Denum
33, Assistant Corporate Secretary

Marc Kilbride
35, Assistant Secretary and Assistant Treasurer

Kevin P. Loughnane
31, Assistant Treasurer

Rufus S. Scott
44, Assistant Corporate Secretary

Robert E. Smith
43, Assistant Corporate Secretary

Directors

Charles E. Bishop, Ph.D
66, President Emeritus of University of Houston System, Houston, Texas, director since 1983.

Searcy Bracewell
70, Advisory Director of Shearson Lehman Hutton, Inc., Houston, Texas, director since 1977.

John T. Cater
52, President and Chief Operating Officer, MCorp, Houston, Texas, director since 1983.

Hollis R. Dean
62, Executive Vice President and Chief Financial Officer of the Company, Houston, Texas, director since 1977.

Joseph M. Hendrie, Ph.D
63, Consulting Engineer, Bellport, New York, director since 1985.

Howard W. Horne
61, Chairman of the Board of The Horne Company, Houston, Texas, director since 1978.

Don D. Jordan
55, President and Chief Executive Officer of the Company, Houston, Texas, director since 1974.

James R. Lesch
66, Retired Chairman of the Board of Hughes Tool Company, Houston, Texas, director since 1982.

Thomas B. McDade
64, Consultant to Texas Commerce Bancshares, Houston, Texas, director since 1980.

I. A. Naman
70, Chairman of the Board of I.A. Naman + Associates, Inc., Houston, Texas, director since 1983.

Kenneth L. Schnitzer, Sr.
58, Chairman of the Board of Century Development Corp., Houston, Texas, director since 1983.

Don D. Sykora
57, Vice President of the Company, Houston, Texas, director since 1982.

Jack T. Trotter
61, Chairman of First Interstate Bank of Texas, Houston, Texas, director since 1985.

Joe C. Wessendorff
70, engaged in ranching and personal investments, Richmond, Texas, director since 1979.

HOUSTON LIGHTING & POWER COMPANY

Officers

Don D. Jordan
55, Chairman and Chief Executive Officer

Don D. Sykora
57, President and Chief Operating Officer

Jerome H. Goldberg
57, Group Vice President Nuclear

Hugh Rice Kelly
45, Senior Vice President, General Counsel and Corporate Secretary

D. F. Simmons
63, Group Vice President Power Operations

Ray J. Snokhous
58, Group Vice President External Affairs

Edward A. Turner
60, Group Vice President Administration and Support

Allen R. Beavers
64, Vice President Project Consultant

L. G. Brackeen
54, Vice President Fossil Fuel Resources

James S. Brian
40, Vice President Finance and Comptroller

Ross E. Doan
58, Vice President Human and Information Resources

Jack D. Greenwade
48, Vice President System Operations

Lawrence B. Horrigan, Jr.
53, Vice President Purchasing and Materials Management

R. Steve Letbetter
39, Vice President Regulatory Relations

Ancel D. Maddox
47, Vice President Customer Relations

David G. Tees
43, Vice President Energy Production

Gerald E. Vaughn
45, Vice President Nuclear Operations

Ken W. Nabors
44, Treasurer

Rufus S. Scott
44, Associate General Counsel and Assistant Corporate Secretary

Gretchen H. Denum
33, Assistant Corporate Secretary

Frank C. Gemar
50, Assistant Secretary and Assistant Treasurer

PRIMARY FUELS, INC.

Officers

Don D. Jordan
55, Chairman

Bill E. St. John
55, President

Duane C. Radtke
39, Group Vice President
North America

James N. Alsup
41, Vice President Finance, Treasurer and Assistant Secretary

Frank L. Cascio, Jr.
40, Vice President Land and Corporate Secretary

Kenneth R. Stout
63, Vice President
International

Kenneth W. Harbin
49, Vice President
Midland District

Ruth W. Simms
33, Comptroller

UTILITY FUELS, INC.

Officers

Don D. Jordan
55, Chairman

F. Ken Smith
53, President

Hollis R. Dean
62, Vice President

Charles L. Merka
50, Vice President
Operations

Lawrence J. Rogers
41, Vice President
Business Development

John J. Bartell
50, Secretary and Treasurer

Ronald D. Baalman
38, Comptroller

INNOVATIVE CONTROLS, INC.

Hollis R. Dean
62, Chairman and Chief Executive Officer

KBLCOM INCORPORATED

Don D. Jordan
55, Chairman

HOUSTON INDUSTRIES FINANCE, INC.

Hollis R. Dean
62, Chairman

DEVELOPMENT VENTURES, INC.

Robert B. Dyer
51, President

HOUSTON INDUSTRIES INCORPORATED SHAREHOLDER INFORMATION

Annual Meeting
The annual meeting of shareholders will be held May 18, 1988 at 10 a.m. in the Electric Tower, 611 Walker, Houston, Texas. A formal notice of the meeting accompanied by a proxy statement and proxy form will be mailed to shareholders beginning on or about April 8, 1988.

Executive Offices
Five Post Oak Park, P.O. Box 4567, Houston, Texas 77210. Telephone: (713) 629-3000.

Stock Listing
Houston Industries common stock is traded under the symbol HOU on the New York, Midwest and London Stock Exchanges.

Transfer Agent and Registrar For The Common Stock
Houston Industries Incorporated, Investor Services, P.O. Box 4505, Houston, Texas 77210

Auditors
Deloitte Haskins & Sells, Houston, Texas

Counsel
Baker & Botts, Houston, Texas

Dividend Disbursing Agent For The Common Stock
Houston Industries Incorporated

Dividend Reinvestment For The Common Stock
The Company maintains a dividend reinvestment program which enables shareholders to automatically reinvest dividends in Houston Industries common stock. For information, contact Investor Services, Houston Industries Incorporated, administrator for the Dividend Reinvestment Plan.

Shareholder Questions
Shareholders may call or write Investor Services regarding questions about their stock and related matters. Shareholders in Houston may call (713) 629-3060. Texas residents may call toll free at 1-800-392-4261. In the rest of the U.S. the number is 1-800-231-6406. Questions regarding preferred stockholders' accounts and dividends or first mortgage bond accounts and interest payments for HL&P should also be directed to Investor Services.

Financial Information
Prospective investors, analysts and representatives of financial institutions requiring information regarding Houston Industries should contact Dan Bulla, Director of Financial and Public Relations, (713) 629-3120, at the executive offices.

SEC Form 10-K
A copy of the annual report to the Securities and Exchange Commission on Form 10-K and other corporate documents may be obtained without charge upon written request to: Robert Smith, Assistant Corporate Secretary, at the executive offices.

HOUSTON INDUSTRIES INCORPORATED
P.O. Box 4567
Houston, Texas 77210