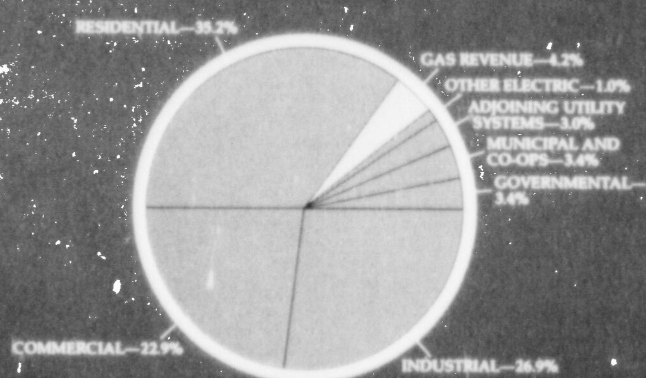
MIDDLE SOUTH UTILITIES, INC.

ANNUAL REPORT

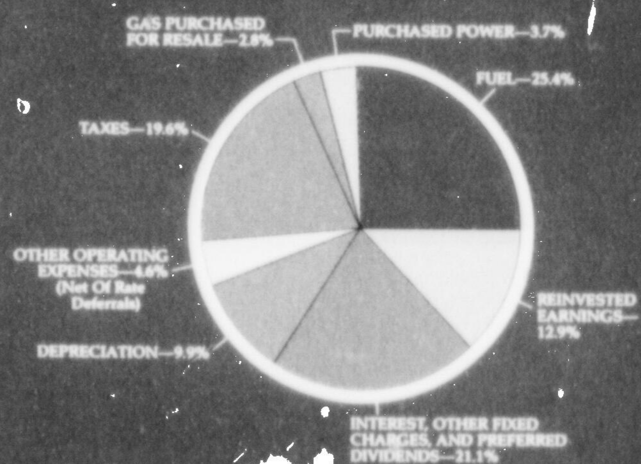
PERFORMANCE HIGHLIGHTS

	1986	1985	% Increase/ (decrease)
Total operating revenues (millions)	[illegible]	[illegible]	7.6
Total operating expenses (millions)	[illegible]	[illegible]	(7.5)
Fuel, purchased power & purchased gas costs (millions)	[illegible]	[illegible]	(17.8)
[illegible] (millions)	$ [illegible]	$ [illegible]	[illegible]
Operating income (millions)	[illegible]	$ 716	62.3
Allowance for Funds Used During Construction (millions)	$ [illegible]	$ 364	(97.7)
Net income (millions)	$ [illegible]	$ [illegible]	12.5
Rate of return on average common equity	[illegible]	[illegible]	[illegible]
[illegible] per common share	$ [illegible]	$ [illegible]	[illegible]
[illegible]	$ [illegible]	$ [illegible]	[illegible]
[illegible]	$ [illegible]	$ [illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	7.6
[illegible]	[illegible]	[illegible]	2.5

Sources of Revenue in 1986



Uses of Revenue in 1986



Note: A description of the Company's business and the service area map appear on the inside back cover; [illegible] frequently used in this report [illegible] Investor Information on page [illegible].

COVER:
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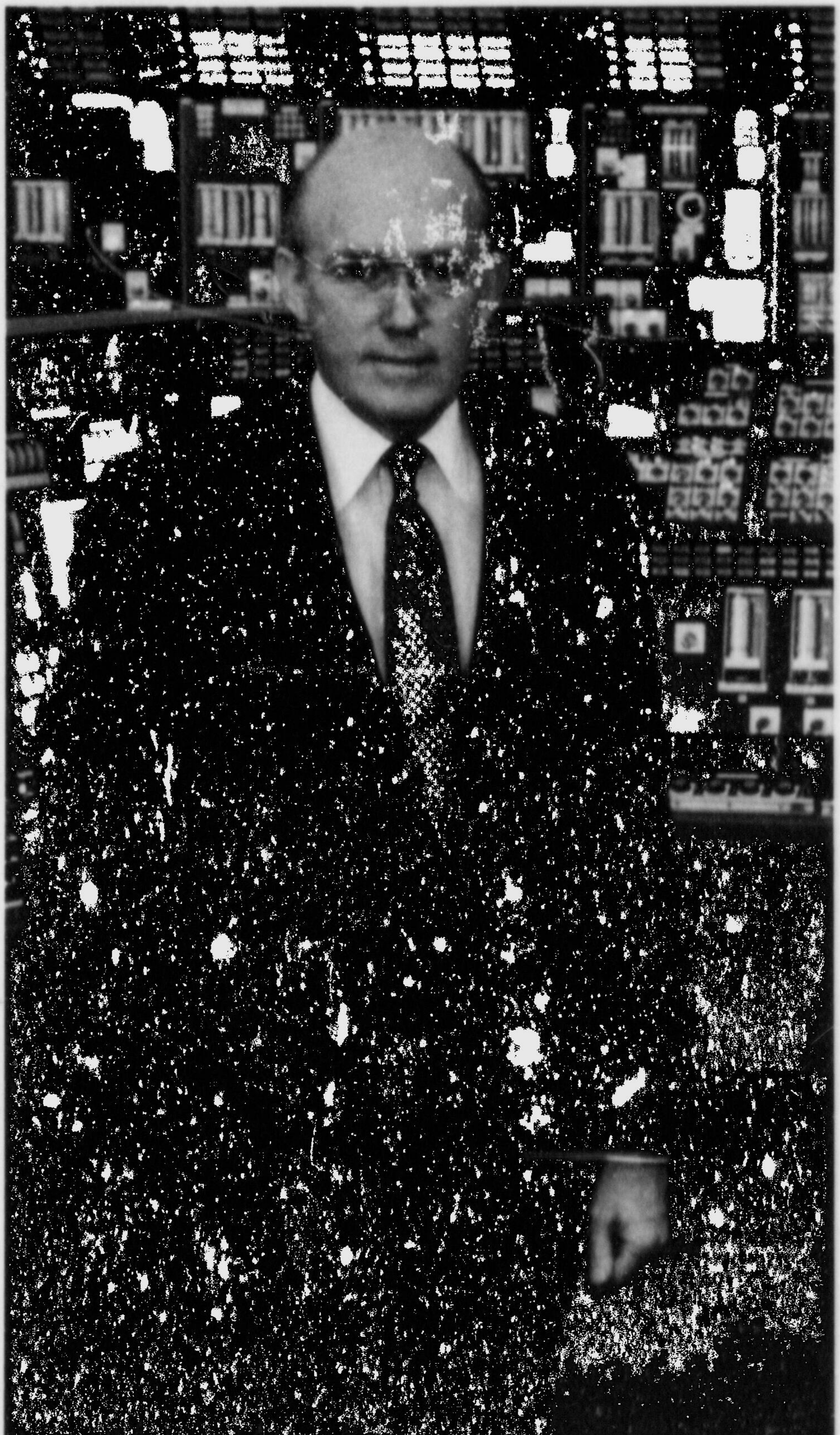
Chairman's Letter

Financial, Operational Progress Achieved in '86



Dear Stockholders:

Middle South Utilities, Inc. has improved operationally, as well as financially, since I wrote to you in last year's annual report.

Nevertheless, a Middle South stockholder's most tangible and legitimate gauge of operational and financial improvement, a dividend, has not appeared.

A dividend reinstatement, at any level, is a signal that stability is returning, and it can only be justified when we have reached a point in our recovery where a dividend can reasonably be expected to be protected and maintained. We are striving vigorously to reach that point.

However, a fact that we are obligated to impress upon our stockholders is that the possibility of our progress being halted or reversed, due to regulatory or judicial developments, cannot be ruled out. This is a realization that we have had to live with in the more than two years since we began applying for and implementing rate increases in connection with the commercial operation of two of our nuclear plants, Grand Gulf Unit 1 and Waterford 3.

We were painfully reminded of this fact on February 25 when the Mississippi Supreme Court reversed and remanded to the Mississippi Public Service Commission (MPSC) the $326.5 million Grand Gulf 1 rate case of our Mississippi Power & Light (MP&L) subsidiary.

Originally decided in September 1985, the rate case involved the phasing in of Grand Gulf 1 costs primarily over a 10-year period. The case was remanded to the MPSC for a review of the prudence of MP&L's involvement in the Grand Gulf project.

It is our position that federal jurisdiction, specifically that of the Federal Energy Regulatory Commission (FERC),

Edwin Lupberger, chairman and president, stands in the foreground of the control room simulator used to train operators at the Company's Grand Gulf Nuclear Station.

Chairman's Letter

takes precedence over state jurisdiction in this issue. We are seeking a rehearing and stay by the Mississippi Supreme Court. Should this prove unsuccessful, we will immediately seek review by the U.S. Supreme Court and request a stay (which cannot be assured) to keep the rates now in effect in place.

In the long run, seeking review by the U.S. Supreme Court may be the best way to decisively resolve the jurisdictional question and the prudence issue, once and for all.

Prudence investigations, reviews focusing on a utility's decision to build a new plant or buy power from one, have occupied two of our other operating companies: Louisiana Power & Light (LP&L) and New Orleans Public Service Inc. (NOPSI). The review of NOPSI, being directed by the New Orleans City Council, is continuing.

Findings were favorable to LP&L in the investigation ordered by the Louisiana Public Service Commission (LPSC). Theodore Barry & Associates, a national consulting firm employed by the LPSC, concluded in an October 1986 report that: LP&L's decision to build Waterford 3 was reasonable and the nuclear option justified; no more than $143 million of the total Waterford 3 construction cost could be classified as imprudently incurred; and Grand Gulf was a reasonable alternative to meet projected LP&L system demand.

While we disagree with the study's conclusion that $143 million was imprudently spent, this amount is less than the $284 million permanent disallowance agreed to by LP&L in its November 1985 rate settlement agreement with the LPSC, meaning that we anticipate no additional disallowance.

I intend to give you an updated report on this entire jurisdictional and prudence issue by the time of the Company's Annual Meeting in May.

For a more detailed report of financial and regulatory developments, you may want to refer to the Management's Financial Discussion and Analysis (MFDA) section beginning on page 14, to Note 2, Rate and Regulatory Matters, beginning on page 27, and to Note 8, Commitments and Contingencies, beginning on page 36.

Other obstacles resolved
Many of the other financial and regulatory dilemmas that threatened the Company as we began 1986 were resolved or their magnitude lessened.

In my 1985 Letter to Stockholders I listed the major obstacles to Middle South's return to financial stability: approval of rates sufficient for NOPSI to meet its Grand Gulf 1 power costs had yet to be granted; the external financings needed to gradually phase in the rates related to new generating units had yet to be arranged, as had the refinancing of Middle South Energy's (now System Energy Resources, Inc.—SERI) sizeable bank loans; the future status and regulatory treatment of Grand Gulf 2 was unknown; and a proposed change in accounting standards threatened the equity and earnings positions of certain of our companies. Now, a year later, I can report that all of these obstacles are being addressed, and some have been resolved to our satisfaction. Certain of these issues remain as obstacles, but we believe none pose as significant a threat.

For instance, in the case of SERI's bank loans, we successfully completed the largest single first mortgage bond financing in electric utility history—$750 million—and reduced our exposure to floating interest rates by replacing much of the bank debt with first mortgage bonds. In fact, our financing and refinancing efforts in 1986, driven by the opportunity to participate in a more favorable capital market, generated more money—over $2 billion—than in any year in our history. And, significantly, almost all of the capital was used to refinance existing indebtedness, meaning that current capital needs were for the most part funded by internal sources rather than through reliance on external borrowing.

The effect of 1986's financing program is that, while our need for external financing remains a factor to be reckoned with, our requirements have become much more manageable.

The renewed confidence in the MSU System was due in large measure to the implementation of phase-in rate plans during late 1985 and early 1986 for the recovery of costs associated with the commercial operation of Grand Gulf 1 and Waterford 3.

With the new rates in effect, the Company's total operating revenues for 1986 increased by 8 percent, to $3.5 billion. Our earnings per share of $2.21, 20 cents higher than 1985's $2.01, resulted from 1986 consolidated net income of $451 million, compared with 1985's $401 million.

While having the rate plans in place has given us a sturdier foundation from which to launch our recovery, these plans also produced a financial recovery pace considerably slower than we would like. Moreover, the rate structures provided by certain of the operating subsidiaries' rate plans, in addition to that of MP&L, are the subject of continuing regulatory proceedings and challenges (see MFDA, pages 14 and 15).

On another front, two potentially disruptive issues mentioned in my letter last year, the change in accounting standards for financial reporting by regulated companies and provisions of the new federal tax law, have turned out to be manageable.

Two judicial decisions in early 1987 reflected further positive developments. A federal appeals court on January 6 affirmed the FERC's jurisdiction in the allocation of Grand Gulf 1 costs among the System operating companies. On January 12, a U.S. District Court in New Orleans issued a judgment dismissing a civil suit alleging, among other things, that certain parties including Middle South Utilities violated Securities and Exchange Commission disclosure requirements.

Although both decisions are being appealed, we are encouraged that our position was supported by the courts.

More recently, the LPSC granted LP&L a rate order entitling it to a

$76 million rate increase and the right to retain $386 million received in an earlier settlement of a contract dispute with a gas supplier. The phase-in plan for Waterford 3 costs previously contemplated by the LPSC's November 1985 interim rate order was replaced with a permanent rate structure that permits current cash receipt of Waterford 3 costs, although the net effect may mean lower returns on investment than were earlier granted to LP&L.

Additionally, intervenors in the proceedings have filed a motion for rehearing with the LPSC and asked for a stay of the order pending an LPSC decision to grant or deny the motion. We are working toward a final resolution in this matter that will be acceptable to all parties.

Options preserved

Regarding another matter discussed last year, we decided in 1986 that the wisest thing we could do regarding the partially complete Grand Gulf 2 nuclear unit was to preserve our options for the future. Following a year's review, we determined in December that a decision to abandon or resume construction of the unit would be premature. Considering the uncertainties of the energy marketplace, we resolved to continue suspension of Grand Gulf 2 construction for up to three years. The continued suspension of Grand Gulf 2 affords us the opportunity to make a more informed decision at a later date, and is, in our view, the option that best serves both Middle South's stockholders and customers.

Long-term programs began to pay off in 1986, as well. With Grand Gulf 1 and Waterford 3 in commercial operation, our fuel diversification efforts, which began in the late 1960s, proved beneficial. In 1986, our nuclear-generated power increased by almost 24 percent, resulting in a substantial decrease in the amount of power purchased from companies outside the System. By year's end each of our three primary fuel sources—nuclear, gas, and coal—was contributing roughly a third of our total fuel requirements. This fuel flexibility enhances our competitive position, particularly in fluctuating fuel price and supply situations.

Focus turned on region

Early in 1986 we also began implementing a comprehensive program to increase the economic and educational opportunities in the Middle South region. We looked hard at our region—its problems, benefits, and potential—and began working in coordination with our operating companies, civic organizations, government agencies, and community leaders toward a common goal of making the region a better place in which to work and live. (See the Economic Development section beginning on page 5.) What we're trying to achieve is a better educated workforce, a more diversified economy, and a skilled entrepreneurial class that can make a lasting, meaningful contribution to the Middle South's economic and cultural base. We believe our efforts, and those of others who share a similar commitment, will succeed and the wide spectrum of programs begun will stimulate business and economic activity in the region, with an ultimate benefit to our Company and our stockholders.

As we work to stimulate change for the better externally, we are doing the same internally. We are acutely aware that our marketplace is being reordered. Competition is becoming a force affecting our marketing program, and we are responding.

On a broader base, we have developed a management structure that positions us to respond effectively and uniformly on high-impact issues affecting Systemwide policy. At the same time, we are instilling a new spirit of Systemwide teamwork.

Looking ahead in 1987 and longer term, we see Systemwide teamwork as a key ingredient in our plan for meeting new performance targets. The Systemwide identity we are forging will enable Middle South to achieve and maintain an effective response to the industry-wide standards and the competitive forces that continue to develop and influence our business plan.

In conclusion, I want to emphasize that Middle South's Board of Directors is steadfast in its commitment to reinstate a common stock dividend. This remains the Board's number one priority. Uncertainties, such as the decision by the Mississippi Supreme Court, make the Board's deliberations most difficult. In view of this and other obstacles that remain, we cannot now realistically set a target date for reinstatement.

We are striving to remove more of the uncertainties that confront us. At the same time, the Company's recovery must continue until a position of financial health is reached where a setback can be handled without placing a dividend, however small, in jeopardy. I eagerly look forward to the day I can announce that we have arrived at this point.

Sincerely,

Edwin Lupberger
Chairman and President
March 16, 1987

Stimulating Business Growth in the Middle South

Company-wide commitment to regional development goals

During 1986 Middle South Utilities, Inc. renewed and reinforced its commitment to regional economic development. The Company viewed an improving economy in Arkansas, Louisiana, Mississippi, and southeastern Missouri as more than a timely objective. Economic development became a business necessity.

Because Middle South Utilities, Inc. is unable to relocate as business conditions change, the Company accelerated its efforts to improve conditions at home by nurturing growth within its service area.

A utility's decision to pursue economic development in its service area is simply smart business. Clearly it is a worthwhile goal, but selecting the goal of economic development doesn't guarantee success. Accordingly, Middle South did more than simply decide to pursue economic development. They went at it with commitment, enthusiasm, and imagination, an approach that has helped make this 37-year-old organization the nation's fourth largest electric and gas utility.

Edwin Lupberger has demonstrated his own commitment to this economic development effort since assuming the Company's chairmanship and presidency in December 1985. "We didn't embark on this without a great deal of preparation," said the 50-year-old Lupberger. "During this first year we've spent considerable time positioning the Company and formulating new programs designed to achieve economic development."

Now that the initial staffing has been accomplished, more emphasis will be placed on meeting specific goals. "For Middle South," Lupberger said, "economic development efforts will entail local and national projects, and we will look to generate international recognition for the region."

As an example of involvement in national projects, Lupberger cited the Middle South System's assistance to Martin-Marietta, Inc.—helping that company in its efforts to secure the NASA space station contract. He also commented on a recent series of Western European business conferences attended by Middle South representatives as an example of efforts to develop interest among foreign businessmen.

The national and international efforts are simply larger examples of similar activities pursued by each of the Middle South System's operating companies. Expanding and creating industry throughout the Middle South region represents the common ground for all of the companies' marketing efforts.

The industrial sector is a key to the System's marketing efforts, said Arkansas Power & Light Company's (AP&L) Kenneth Breeden, vice president of marketing. "New industry—and new industrial electric demands—invariably translate into increases in employment which also translate into added residential electric load as new employees find homes," he explained. "In addition, higher commercial loads are produced as those employees support expanded services where they live. It's the old multiplier effect."

The economic development prescription can be a complex formula. Its combination of ingredients can vary greatly among such economic inducements as discounts for services and other pricing incentives, offers of government-backed job training programs, tax credits based on the number of new jobs created, and a variety of other, often innovative, methods of generating capital including revenue bonds, low-cost loans, and other avenues to achieve access to reservoirs of venture capital. States, municipalities, and the Middle South System operating companies themselves participate in these marketing efforts.

In an 18-month period AP&L, for example, offered industrial incentive contracts to 82 companies that had increased their electricity demands by a minimum of 500 kilowatts a month. The contracts allow rate discounts based on the demand increases, which usually correspond to increased operations and more jobs. In one instance, an El Dorado-based outdoor lighting manufacturer's demand for more electricity was matched by the hiring of 90 additional workers. In a second instance, a Batesville poultry firm eligible for the rate discount added 20 employees.

Prior to 1986, the operating companies in the Middle South System approached the business of economic development individually. Mississippi Power & Light Company's (MP&L) "Helping Build Mississippi" program serves that company's region, as does its "Energy Plus" program, a five-year effort begun in 1985 and designed to create 14,000 job opportunities for the state's workforce by the end of 1990. Similarly, Louisiana Power & Light Company (LP&L) and New Orleans Public Service Inc. (NOPSI) encourage economic development by offering their own rate incentive packages and by participating in a statewide program known as "Ready Cities" that trains and certifies communities in the increasingly sophisticated task of attracting new businesses.

AP&L produces similar successes by involving its marketing department in the economic development effort. At AP&L, the marketing department's account executives offer full service assistance to businesses, and combine with an in-house Community Development Program to blend

The Company's System Executives act on Systemwide issues and vital corporate matters. Members of this principal management advisory group are: from left, sitting, Chairman Edwin Lupberger, R. Drake Keith, system executive—finance, and William Cavanaugh, system executive—nuclear; standing, Jack L. King, system executive—operations, and Jerry Jackson, system executive—legal and external affairs.

Regional Economic Development

the development effort with the needs of businesses and the general public.

In 1986, the Company began a more ambitious effort, one that relied on a coalition among the operating companies. The economic development work, while still reflecting a service area priority, has taken on a regional perspective. The programs, called New Opportunities, have been structured by Middle South Utilities, Inc. to expand and intensify economic development efforts across a broad range of businesses, industries, and trades.

Launched in the summer of last year, New Opportunities is the Middle South operating companies working in concert to promote the untapped potential of the entire region.

The effort makes good business sense, Lupberger pointed out. "The role of promoting economic development in a region is a need that we (Middle South Utilities, Inc.) are uniquely qualified to fill. We're the major private enterprise serving this region. If we develop the territory we serve, that's good business and we shouldn't be ashamed of promoting good business."

Lupberger added, "We've got adequate kilowatt-hours available which allow us to encourage new and expanded businesses. In turn, the greater size and number of businesses enable energy users to share the energy's cost by spreading it over a broader customer base." Blunt, straightforward interpretations of the Middle South region's economic realities are reflected in the New Opportunities programs. The programs are comprehensive, well organized, and thorough.

Commercial development, and its positive economic impact, continues to occur throughout the region. One of the most notable, the Riverwalk development in New Orleans, begins at the city's Spanish Plaza and extends along the riverfront. The collection of stores and restaurants attracts visitors and natives alike.

New Opportunities programs add to economic development efforts

The New Opportunities programs approach economic development from an educational as well as a business perspective. The goal is to ensure continued economic development through reliance on an educated workforce and a motivated business community.

Entrepreneurial workshops, known as Operation Opportunity, will serve as "how-to-do-it" classes for the small businessman.

Project Literacy will address the dilemma of adult illiteracy and will use educational technology to improve adult reading skills.

Speaking of Opportunity, a lecture series, will help motivate and sustain the growth cycle of business. The lectures will feature economic development experts speaking before business conferences, civic, and professional groups.

Project Second Chance is designed to encourage those who have dropped out of school to pursue a GED (high school graduate equivalency) program.

Ambassadors of Economic Development will involve business and community leaders serving as promoters of the Middle South region to audiences outside the region, including international audiences.

The Opportunity for Excellence program will recognize and encourage excellence among students and teachers in the region's high schools.

J. Hugh Nichols was chosen to head the economic development efforts which include the New Opportunities programs. A former Maryland county executive, Nichols' mandate at Middle South is to generate momentum in the areas of education and the general economy. "The resources are there," Nichols said, citing census figures that show the South is the only region of the country to record net in-migration from other areas of the nation.

Keeping that trend intact and shaping it into business development is the goal, he said. "We want the business community to know more about the Middle South region. We want

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this region to be a businessman's first choice when it comes to expansion or relocation." The economic development program will be comprehensive and include business development programs targeted to industries with a high probability of success in the Middle South region.

Lupberger said the New Opportunities efforts also benefit from the full support of the Middle South Board of Directors, and described the programs as "well received by educators and businessmen. After a year," he said, "we might look at our effort as a large wheel that's taken a while to get rolling, but now we're developing momentum."

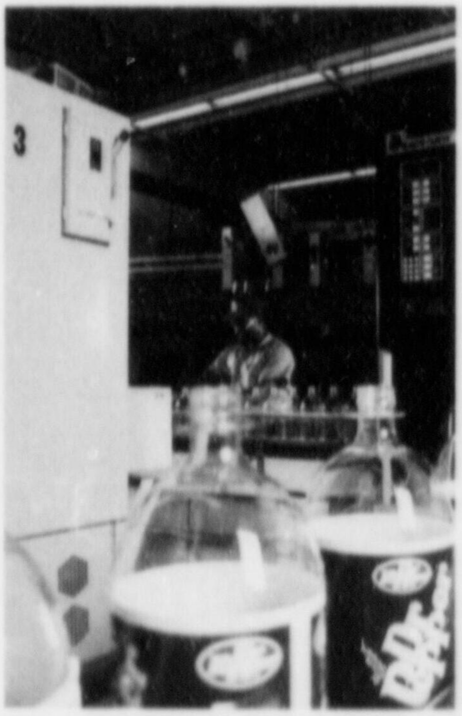
Shaping a competitive edge, marketing a regional image

That momentum will inevitably lead to accomplishments that will one day match the successes recorded individually by AP&L, LP&L/NOPSI, and MP&L. Each operating company has achieved successes in the form of expanding existing industries and attracting new ones. In 18 months AP&L's efforts have contributed roughly 3,300 new jobs to the company's Arkansas and southeast Missouri service territory. LP&L/NOPSI's efforts, meanwhile, have accounted for more than 1,200 new jobs, even though Louisiana has been burdened by an unemployment rate that led the nation during 1986, peaking above 13 percent.

Jim Cain, LP&L/NOPSI president, met the Louisiana challenge by overseeing development of a strategy "based," he said, "on rate structures and contracts that allowed our industrial customers to remain competitive and maintain employment in our area."

LP&L/NOPSI is also actively implementing and expanding programs that

Processed lumber, stacked high at this Cavenham Forest Industries facility in McComb, Mississippi, and a variety of wood and paper products have long been major facets of the region's economy.



Gulf States Canners cooperative in Clinton, Mississippi, serves soft drink distributors from northern Florida to eastern Texas.

improve educational achievement. Special emphasis has been placed on Operation Mainstream, a program that combats adult illiteracy. As Cain explained, "There is a high degree of public awareness in our area of the link between the quality of education and the area's economic development potential." The result is success on two fronts and the momentum to achieve more.

Meanwhile, MP&L has been credited with creating more than 3,000 manufacturing jobs in its service area and has taken aim at a 14,000-job goal for its service area by 1990 through its Energy Plus program.

"Our first responsibility is to provide reliable energy service, and we take that responsibility seriously," said Donald Lutken, MP&L chairman and president. "But I would also like to think we are providing Mississippi something more than just electric energy. We are also a source of personal energy, the kind that comes with the total commitment to 'Helping Build Mississippi.' "

Through the years the company has been recognized by the communities of western Mississippi for this effort.

A recent editorial in the Tylertown, Mississippi, "Times" began with the headline, "Thanks, MP&L." The editorial followed an announcement that American Fabrics of New York would hire 150 people to manufacture lace in a vacant facility in that town. In researching for an article on the location, the editor of the "Tylertown Times" discovered that the building was first constructed in 1946 to accommodate another company that was also introduced to the city by MP&L industrial representatives.

"Helping Build Mississippi" has been the theme for MP&L's economic development program for many years. It is a program that has operated in one form or another in Mississippi since 1928 and has succeeded in attracting new companies and convincing existing companies to remain, often with expanded operations.

MP&L's efforts succeed because the area development representatives are "full service" professionals. The department's economic development, community development, and economic research staffers are trained to assist in negotiating the maze of regulations and financial programs of federal, state, county, and municipal governments.

The results achieved by MP&L representatives are measured in terms of dollars and cents. Hygiene, Inc., for instance, a Sardis, Mississippi, maker of vinyl and fabric household products, was looking at alternative sites outside MP&L's service area prior to contact by an area development representative. After learning of the incentives available from a variety of sources, Hygiene decided not only to remain in Sardis, but expand its operations into a 100,000-square-foot addition. The

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capital investment totaled $3 million and resulted in 75 new jobs.

A similar development took place at Gulf States Canners in Clinton. A more than 30-member cooperative that cans and distributes soft drinks from northern Florida to eastern Texas, Gulf States completed a $9.5 million expansion. The project accounted for an additional 50 employees and an increase in the system load totaling 1,400 kilowatts.

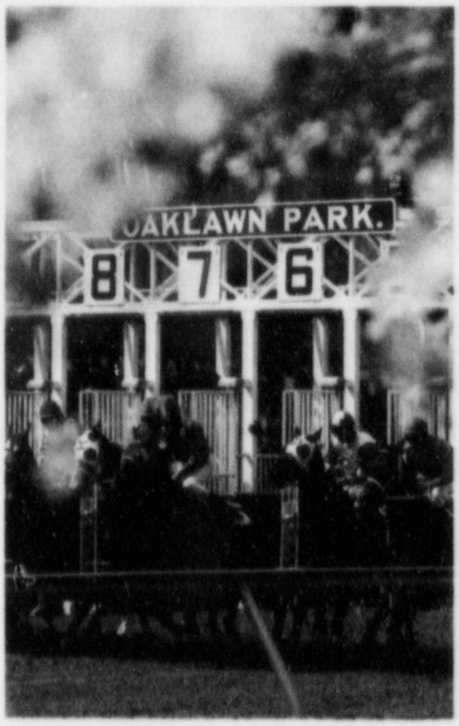
MP&L's efforts have attracted new companies as well, including UNR-Leavitt's tubular steel facility in Madison County, the Groen Division of Dover Corporation's commercial cookware plant in Jackson, and Hunter Engineering's automotive diagnostic equipment plant in Raymond.

MP&L's incentive pricing for new and expanding industrial customers also proved successful in 1986. With discounts based on added kilowatts, the company contracted for major expansions in 28 industries in nine months. The contracts guaranteed creation of over 1,000 new jobs and added more than $70 million in new industrial investment.

"We see Mississippi building on the traditional manufacturing operations to the new, upscale, capital intensive, technological industries which will power the American economy for years to come," said Lutken. "And MP&L will remain in the forefront."

At the operating companies, marketing has become a discipline, a science fueled by equal parts of data and encouragement. The idea is to give customers—in this case electricity users—as much data as they want and as much encouragement as they need.

Chicken farming is big business in the region. This 360-foot-long coop on Meredith Miller's farm in Boone County, Arkansas, houses 13,000 chickens that consume a ton of chicken feed every day until the birds are sold to poultry processors and distributors.



The Sport of Kings draws crowds to Hot Springs, Arkansas' Oaklawn Park from February to mid-April.

AP&L's marketing efforts target the top 150 industrial accounts. Account executives are assigned to "industrial segments such as oils and chemicals, metals and mining, paper mills, food processing, and manufacturing," AP&L President and CEO Jerry Maulden said. "We chose those segments because they represent our major customer mix and are traditionally the major sources of industrial jobs in AP&L's service area."

The relationship between the company's account executive and the industry is designed to enhance the industrial customer's ability to compete.

Maulden said the "hand-picked account executives are expected to learn as much as possible about their assigned field in order to assist their customers' management as much as possible. Anything we can do to enhance a customer's competitive position," he continued, "improves a company's chances for success and, ultimately, produces a profitable development for AP&L."

Tools used to foster economic development vary from company to company within the Middle South System, but all are dependent upon meeting the customers' electrical needs reliably, efficiently, and economically. AP&L's account executives introduce customers to alternatives such as: Demand Discounts, Interruptible Service, Rate Guarantee on Demand Charges, Prepayment of Demand Charges, Formula Rates, and Start-up Rates.

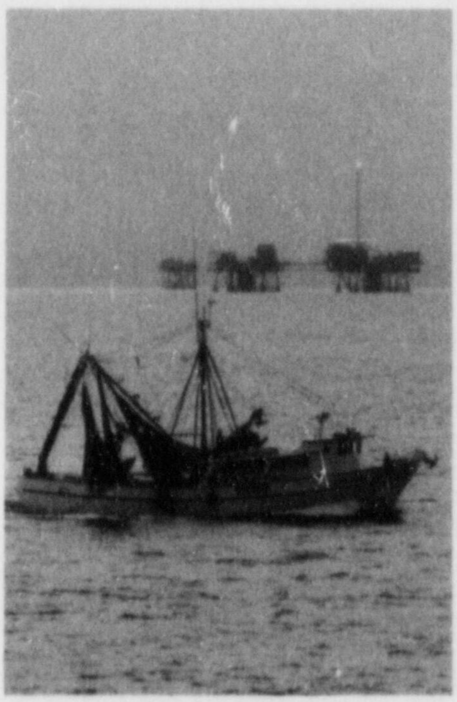
The programs are innovative, tailored to specific industries, and they encourage a partnership between AP&L and industrial customers. The goals of the programs are: additional industrial production, rate stability and predictability, and active involvement in emerging energy technologies.

LP&L/NOPSI representatives pursue the same goals for the service-oriented, commercial businesses of New Orleans, and for the burgeoning seafood-processing industry springing up along the broad expanses of the state's coastline and on through its northern plains. Area Development Engineers keep businessmen and entrepreneurs informed about the benefits LP&L/NOPSI can offer.

There is room for generosity in business. In most cases, thoughtfully exercised generosity is good business. In Louisiana, Jim Cain organized a response to the downturn in the state's economy that resulted in an almost complete retention of the company's industrial base.

"Although the strategy called for giving up valuable revenue for the short term—at a time when every penny was needed to complete our nuclear program—the effort kept the loss of load and plant closings to a minimum," Cain said. While other utilities in the region lost as much as 1,100 megawatts of load, LP&L/NOPSI maintained its industrial base.

Regional Economic Development



Fishermen harvest the Gulf of Mexico's seafood, while offshore rigs mine the hydrocarbons beneath the sea floor.

Benefits for the region and for Middle South Utilities

Seafood processing is a major target of the LP&L/NOPSI effort which concentrates on the processing operations that flourish along waterways like Petit Caillou and Bayou LaFourche, and in communities like Cocodrie, Pointe au Chien, and Chauvin.

The industry has grown as the oil and gas exploration and production segment has declined. It will continue to grow. U.S. Department of Agriculture estimates show consumer prices for fish and other seafood rising 9 percent in 1987, duplicating the 9 percent price rise recorded in 1986. Moreover, more than 60 percent of the seafood consumed in the United States is imported, a figure that underscores the potential a domestic seafood industry offers for the U.S. and for Louisiana, in particular. In addition to flexible incentive packages, which can be expanded with the approval of the governor's office, Louisiana's naturally superior ports and waterways systems are further inducements to economic development, as is the state's highly productive workforce.

LP&L/NOPSI also participates in the "Ready Cities" program as a means of attracting business and keeping it. The program encourages a group of business and civic leaders in any community of 1,500 to 25,000 to perform a sort of self-analysis that measures their community's ability to promote economic development. The analysis provides a means to inventory community assets, develop and train a community sales team, and help formulate a strategy to generate jobs in the community.

Once in place, the "Ready Cities" program relies on that cadre of business and civic leaders as economic development spokesmen for the community.

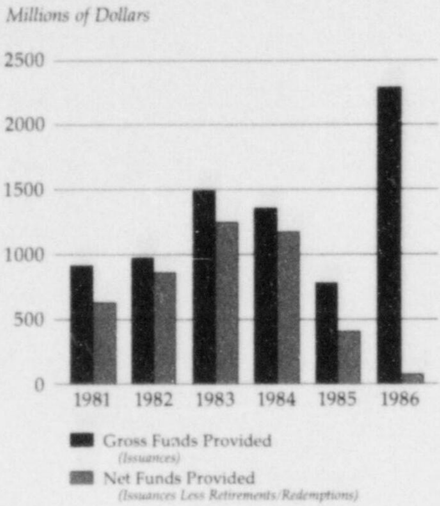
The thrust of this region-wide economic development effort has been one of commitment and cooperation among Middle South Utilities, the System's operating companies, and the states they serve. Working in concert, the effort is improving the region economically and socially by means of the educational advancements that are part of the programs. "We felt that in order to realize the successes we envisioned, we first had to get the region thinking positively about itself. We had to develop a positive attitude about ourselves and about our ability to do business on a par with any other region of this country," Lupberger said. The stance Middle South Utilities has taken through its programs, both regionally and in the individual service areas, is one of a sincere, committed corporate citizen.

"Sure it benefits us, but that's to everyone's advantage," Lupberger explained. "Our goals stand for positive changes in a region that must improve in order to provide the kind of future the people of the Middle South region and the investors in Middle South Utilities, Inc. expect and deserve.

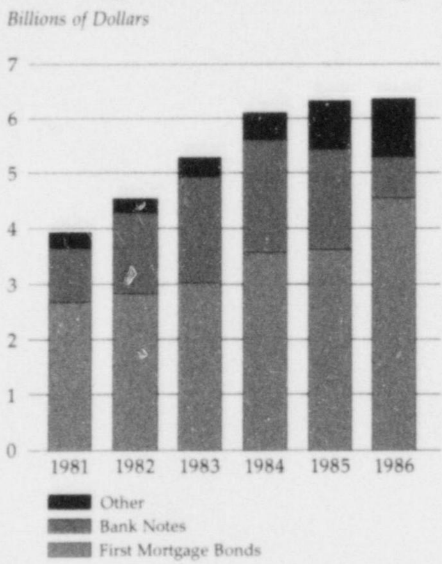
At Foret's dock in Cocodrie, deep in the Louisiana bayou country, shrimp are unloaded from the holds of net-laden fishing boats, boiled, and carted, still steaming, into a processing shed. There the shrimp are dried and packaged for distribution to markets throughout the world.

Management's Financial Discussion and Analysis

External Financing Activity



Total Long-Term Debt Outstanding



Financial Condition

The year 1986 was important in the financial recovery of the Middle South System. Due to rate relief received by the System operating companies in the latter part of 1985 and in the first quarter of 1986, the System recovered from the low point reached during the fall of 1985. Such recovery was evidenced by the upgrading of debt issues during 1986 by certain investment rating agencies and by increased investors' confidence in the System as more than $2.2 billion in financings were completed during the last nine months of 1986 primarily in connection with the refunding and redemption of outstanding indebtedness. However, while the System's financial condition has improved, the final and favorable resolution of disputes over adequate retail rate relief for certain of the System operating companies has yet to be achieved, as certain regulatory authorities continue to examine prudence issues in conjunction with Unit 1 of the Grand Gulf Nuclear Station (Grand Gulf 1) and Unit 3 of the Waterford Steam Electric Generating Station (Waterford 3). Further, as discussed below, MSU has been unable to reinstate its common stock dividend.

As a result of uncertainties facing the System, MSU has been unable to declare its common stock dividend since the second quarter of 1985. Resumption of MSU's common stock dividend depends, among other things, upon the resolution or further modification of these uncertainties as discussed below and continued improvement in the financial condition of the System.

Several uncertainties faced the System during 1986 which had, and in certain cases continue to have, the potential to impede its financial recovery. These uncertainties, which contributed to the System operating companies not declaring common stock dividends, included: the (1) uncertain status of Unit 2 of the Grand Gulf Station (Grand Gulf 2), (2) the potential effect of proposed revisions to Statement of Financial Accounting Standards (SFAS) No. 71, (3) ongoing prudence investigations, and (4) challenges to certain rate orders. Specific developments in respect to these uncertainties that have occurred in late 1986 and early 1987 are listed below.

- On December 5, 1986, the recommendation was adopted by SERI's Board of Directors (with the MSU Board of Directors concurring) to continue the suspension of construction activities on Grand Gulf 2 and to make a decision by 1990 on the future status of Grand Gulf 2. This decision allows the System to maintain flexibility in meeting the energy needs of its service area. (See Note 8 to the Consolidated Financial Statements—"Commitments and Contingencies—Grand Gulf 2.")

- In December 1986, the Financial Accounting Standards Board (FASB) issued SFAS No. 90 which amended SFAS No. 71 with respect to the accounting for plant abandonments and cost disallowances. This standard will require LP&L to write off the $284 million disallowance (less related tax benefits) it agreed to absorb with respect to Waterford 3. This write-off will be accomplished either by restating the appropriate prior years' financial statements or by charging it against net income in the year of such write-off. The new standard provides a transition period which should allow time to minimize the effects of this write-off. (See Note 8 to the Consolidated Financial Statements—"Commitments and Contingencies—New Accounting Standard" for further discussion of this matter and of the FASB's decision to further consider possible changes regarding rate phase-in plans.)

- In October 1986 the consultants retained by the Louisiana Public Service Commission (LPSC) for the prudence investigation of LP&L made public their report in which they concluded that no more than $143 million in expenditures were imprudently incurred on Waterford 3 and that the decisions to build Waterford 3 and Grand Gulf 1 were reasonable. A permanent Waterford 3 rate order, issued in late January 1987 by the LPSC, allowed LP&L a rate increase of approximately $76 million. While the LPSC order embodied no further disallowance of Waterford 3 costs beyond the previously agreed $284 million, the LPSC stated its view that prudence issues remain unresolved. For a more detailed discussion of this complicated order, see Note 2 to the Consolidated Financial Statements—"Rate and Regulatory Matters."

- The June 13, 1985 decision of the Federal Energy Regulatory Commission (June 13 Decision), which allocated the capacity and energy of Grand Gulf 1 among the operating companies, was affirmed by the United States Court of Appeals for the District of Columbia Circuit. (See Note 2 to the Consolidated Financial Statements—"Rate and Regulatory Matters.")
- On February 25, 1987, the Mississippi Supreme Court reversed and remanded the September 1985 order of the Mississippi Public Service Commission (MPSC) granting permanent rate relief to MP&L with respect to its recovery of Grand Gulf 1 costs pursuant to a multi-year phase-in plan. The Supreme Court found reversible error in the MPSC's prior rate order based, in part, on the assertion that the MPSC failed to consider prudence issues. MP&L is continuing to bill rates subject to refund. However, in the absence of a stay pending further appeal, which MP&L is pursuing, but which cannot be assured, MP&L could be required to reduce its rates, refund previously billed Grand Gulf 1 amounts, and/or write-off certain Grand Gulf 1 expenses deferred for later recovery. (See Note 2 to the Consolidated Financial Statements—"Rate and Regulatory Matters.")

The System, as a result of the rate structures established in 1985 and 1986, was able to achieve a modest level of financial recovery. However, additional uncertainties remain such as continuing court challenges of the ruling affirming the June 13 Decision, continuing challenge to MP&L's Grand Gulf 1 rate order, continuing challenges to other rate orders and settlements, ongoing prudence investigations, and various takeover threats which may impact its future financial condition. If, as a result of one or more of these proceedings, the existing retail rate structures of any of the System operating companies were to be revised in a manner that would cause such operating company to absorb (and not recover from customers) substantial Grand Gulf 1 costs, the earnings, liquidity, and financial condition of such operating company and its ability to meet its continuing obligations could be severely impaired. Such company could be rendered insolvent and the Middle South System could be materially and adversely affected.

Liquidity and Capital Resources

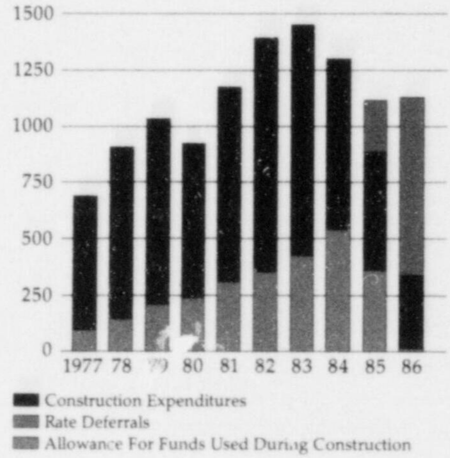
The Middle South System's construction expenditures for the years 1984, 1985, and 1986 were $1,299 million, $876 million, and $335 million, respectively. The System's construction expenditures have been dramatically reduced due to the completion of Grand Gulf 1 and Waterford 3 during 1985. In addition, the full suspension of construction of Grand Gulf 2 is continuing. Reflecting these events, the total System construction expenditures, including Allowance for Funds Used During Construction (AFUDC), for 1987, 1988, and 1989 are estimated to be $465.0 million, $418.2 million, and $457.9 million, respectively.

Significant additional capital requirements, estimated to aggregate $1,030.8 million during the period 1987-1989, will result from the need to finance Grand Gulf 1 rate moderation plans for AP&L, MP&L, and NOPSI and an assumed rate moderation plan in connection with Waterford 3-related costs for that portion of LP&L's service territory under jurisdiction of the New Orleans City Council (Council). The System operating companies' levels of internally generated funds available for capital requirements were improved to a degree during 1986 due to their not paying common stock dividends to MSU.

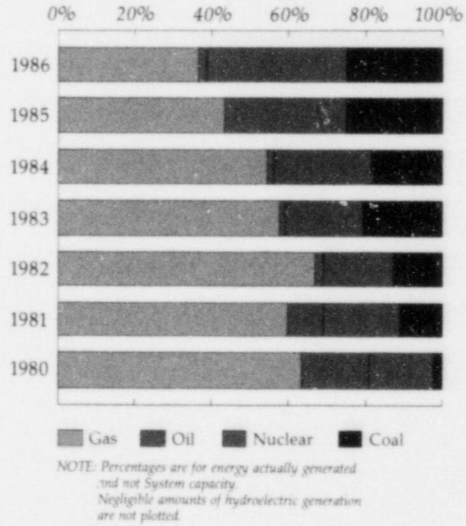
In addition, during the period 1987-1989, the Middle South System will require capital funds of approximately $1,079.7 million from internal and external sources to retire or to refinance maturing debt and to meet long-term debt and preferred stock sinking fund requirements. Also, credit lines in the amount of $461 million are currently scheduled to terminate in 1987-1989 in connection with nuclear fuel leases. Unless the present credit lines are extended or new lines are arranged, the Middle South System will require additional capital funds in order to finance the nuclear fuel as the leases will terminate concurrent with termination of the credit lines. (See Note 9 to the Consolidated Financial Statements—"Leases.") Finally, unless certain financing arrangements of SFI in connection with its nuclear fuel procurement and services program for the Middle South System scheduled to terminate during the period 1987-1989 are extended or

Capital Requirements Related to Construction Expenditures and Rate Deferrals

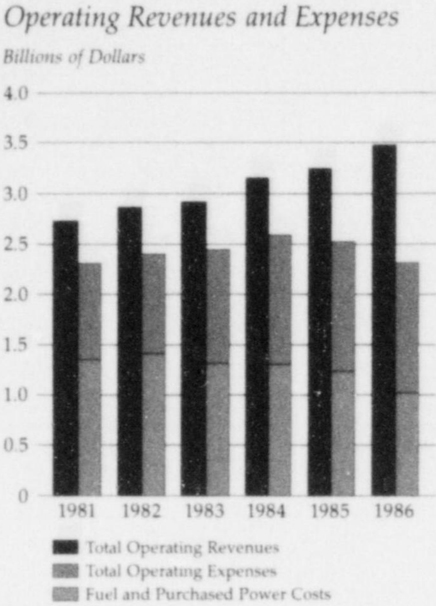
Millions of Dollars



Electricity Generation by Fuel Type (Megawatt-hours)



Management's Financial Discussion and Analysis



alternative financing arranged, additional capital requirements of up to $115 million could result.

The capital requirements of the System operating companies noted above may vary in the event of modification of (1) the rate structures implemented by the System operating companies as a result of prudence investigations or otherwise, (2) the FERC's allocation of Grand Gulf 1 capacity and energy in the June 13 Decision, or (3) its allocation of other energy costs under the System Agreement in the June 13 Decision. The June 13 Decision is the subject of judicial review and the ultimate outcome cannot be predicted. (See Note 2 to the Consolidated Financial Statements—"Rate and Regulatory Matters.")

The System operating companies expect to raise capital funds from external sources through the sale of additional first mortgage bonds, shares of preferred and common stock, and borrowings or such other methods of financing as may be appropriate. NOPSI's ability to engage in traditional first mortgage bond financing is constrained by its limited amount of property additions. As such, it intends to meet its capital requirements during the period 1987-1989 through the use of internally generated funds, short-term borrowings, and other such methods of financing as may be appropriate. In this connection, NOPSI has filed applications with regulatory authorities for approval of a new general and refunding mortgage under which all future long-term debt financing of NOPSI would be accomplished. Under the proposed new mortgage, additional debt could be issued (up to an aggregate of $280 million) by NOPSI to finance deferred Grand Gulf 1 costs without having to satisfy a separate property additions issuance test. NOPSI has filed for approval of a plan to issue up to $75 million of an initial series of debt thereunder. Further, MP&L's ability to issue additional first mortgage bonds is limited by the amount of its available property additions. Consequently, MP&L is studying plans for alternate forms of future debt financing.

The mortgage coverage ratios of the System operating companies and SERI limit the amounts of additional first mortgage bonds that they may issue to finance their construction programs and other capital requirements. Based on these ratios at December 31, 1986, the System operating companies could have issued an aggregate of approximately $2,114 million of additional first mortgage bonds (plus any bonds issued for refunding purposes), subject to the availability of bondable property and assuming an annual interest rate of 10 percent. However, the System operating companies only had sufficient unfunded bondable property available at December 31, 1986, to issue an aggregate of approximately $1,076 million in first mortgage bonds. SERI could have issued approximately $2,937 million of additional first mortgage bonds (plus any bonds issued for refunding purposes), subject to the availability of bondable property, and assuming an annual interest rate of 10 percent. However, SERI's unfunded Grand Gulf 1 bondable property at December 31, 1986, would have permitted the issuance of only approximately $463 million of first mortgage bonds.

The charter coverage ratios of the System operating companies limit the amounts of additional preferred stock that may be issued. At December 31, 1986, LP&L's earnings coverage was such that it was precluded from issuing additional preferred stock while AP&L, MP&L, and NOPSI could have issued preferred stock aggregating approximately $500 million, assuming a preferred dividend rate of 10 percent. The amounts of additional preferred stock and first mortgage bonds which can be issued by SERI and the System operating companies in the future are contingent upon earnings and the amount of unfunded bondable property available to support the issuance of additional first mortgage bonds.

During 1986 certain of the System companies obtained funds externally through sales of $1,750 million of first mortgage bonds, $85 million of preferred stock, $225 million of intermediate-term secured notes, and $195 million of pollution control revenue bonds. As mentioned earlier, most of these financings were in connection with the refunding and redemption of outstanding indebtedness. The System companies have been able to take advantage of the improving credit market to significantly reduce interest and dividend requirements on certain outstanding first mortgage bonds and preferred stock issues.

The System operating companies are currently authorized by the Securities and Exchange Commission (SEC) to effect short-term borrowings in an aggregate amount outstanding at any one time of up to 10 percent of their respective capitalization, subject to the availability of funds through bank lines and other credit sources. At December 31, 1986, the System operating companies had no existing short-term borrowings outstanding under territorial bank lines of credit aggregating approximately $130 million. Further, LP&L had non-territorial bank lines of credit of $110 million, none of which were utilized at December 31, 1986. In comparison, at December 31, 1985, only AP&L and LP&L had territorial bank lines of credit approximating $77.7 million of which $18.7 million was outstanding to LP&L. Additionally, LP&L had non-territorial bank lines of credit of approximately $80.5 million, all of which were fully utilized at year-end 1985. At December 31, 1984, the System operating companies had no existing short-term borrowings outstanding under unused bank lines of credit of $322 million. Additional authorized borrowings of each System operating company can be effected through the Middle South System Money Pool (Money Pool), subject to the availability of funds which at any particular time may be limited. The Money Pool provides the means whereby companies in the System with available funds can lend such funds to other participating System companies (other than MSU). At December 31, 1986, the funds available in the Money Pool for borrowing aggregated $220.9 million of which $26.2 million was borrowed by certain System companies. SERI has SEC authorization to borrow up to the lesser of $200 million or 5 percent of capitalization (approximately $226 million at December 31, 1986) from the Money Pool. (See Note 4 to the Consolidated Financial Statements—"Lines of Credit and Related Borrowings.")

The Company continued the suspension of all further sales of common stock during 1986. Further, in October 1986, the Company terminated its dividend reinvestment and stock purchase plan. The Company presently has available and unused a $60 million line of credit under a bank credit agreement expiring December 31, 1989.

In connection with the Grand Gulf Nuclear Station, the Company has undertaken to provide or cause to be provided to SERI sufficient capital (1) to maintain SERI's equity capital at an amount at least equal to 35 percent of total capitalization (excluding short-term debt), (2) to construct and place in operation the two units of the Grand Gulf Station, (3) to provide for pre-operating expenses and interest charges of SERI, (4) to permit the continuation of commercial operation after commencement thereof, and (5) to pay in full all indebtedness for borrowed money of SERI when due. (See Note 8 to the Consolidated Financial Statements—"Commitments and Contingencies—Potential Debt Acceleration and Related Matters.")

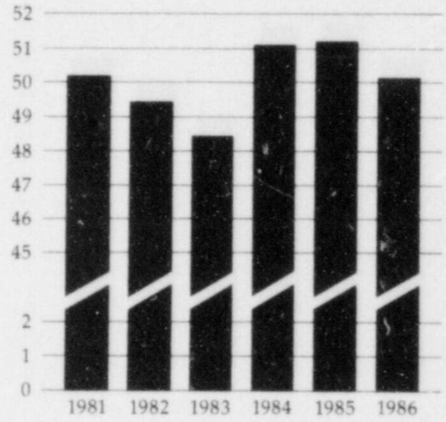
SERI estimates that it will require approximately $942.7 million from internal and external sources for the period 1987-1989 to refinance maturing indebtedness, to meet sinking fund obligations, and to finance its other capital requirements. SERI expects to obtain a significant portion of such funds through its receipt of payments from the allocation of costs associated with Grand Gulf 1 to the System operating companies under the Unit Power Sales Agreement. The balance of amounts needed by SERI will be obtained from external sources, including, but not limited to, additional issuances of first mortgage bonds, additional preferred and/or preference stock and such other sources as may be appropriate.

On October 22, 1986, the President signed into law the Tax Reform Act of 1986 which will have a significant impact on the utility industry. Provisions contained in this law will, among other things, diminish the value of investment tax credit carryforwards, lengthen the period over which utility property can be depreciated for tax purposes, impose a new alternative minimum tax, and reduce the marginal corporate income tax rate.

For the Middle South System the above provisions of the Act will have varying consequences. As a result of significant amounts of net operating loss and investment tax credit carryforwards, these provisions are not expected to have a substantial effect on the System's

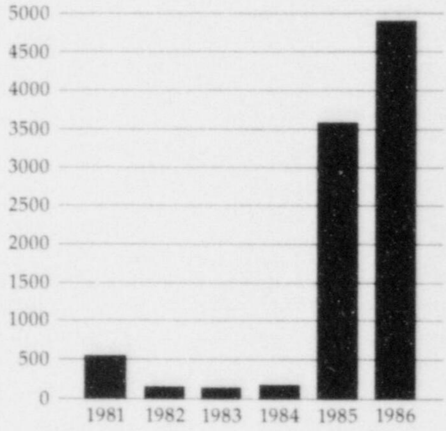
System Retail Customer Electricity Usage

Billions of Kilowatt-hours



Wholesale Electricity Sales to Adjoining Utility Systems

In Millions of Kilowatt-hours



results of operation or financial condition through 1989. However, the future cash flow of the System will be impacted as the lower corporate income tax rates will result in reduced charges to customers. While these reduced collections will lower internal cash generation, cash flow is not expected to be so severely impacted as to substantially increase external financings.

Results of Operations

The Middle South System's net income for 1986 was $451 million, an increase of approximately $50 million, or 12.5 percent, over 1985. This increase was due primarily to (1) the effect of Grand Gulf 1 and Waterford 3 rate increases implemented during the latter part of 1985 and first quarter of 1986, including the rate deferral of $786 million recorded in 1986 as compared with $237 million in 1985 and (2) the recording of provisions for estimated losses as of December 1985 whereby the System operating companies expensed selected engineering and design costs and estimated liabilities associated with indefinitely delayed future fossil generating facilities and with certain investments in the System's fuel procurement program. The recording of such provisions had the net effect of reducing 1985 net income by approximately $66 million. Partially offsetting these factors were (1) the substantial reduction in the amount of AFUDC accrued in 1986 when compared with 1985 (see below), (2) the increased amounts of depreciation expense in 1986 associated with Grand Gulf 1 and Waterford 3, and (3) the recording of additional write-offs in 1986 related to the System's indefinitely delayed future fossil generating facilities (approximately $39.6 million) and SFI's uranium exploration program (approximately $19.2 million).

The System's net income for 1985 was $401 million, a decrease of approximately $107 million, or 21.1 percent, from 1984. This decrease resulted primarily from (1) the effect of Grand Gulf 1 and Waterford 3 having entered commercial operation without retail rates in place on a timely basis to recover costs associated with these units, (2) the cessation of accruing AFUDC on both units upon commercial operation, (3) the previously mentioned recording of provisions for estimated losses as of December 1985 associated with indefinitely delayed future fossil generating facilities and with certain investments in the System's fuel procurement program (See Note 12 to the Consolidated Financial Statements—"Quarterly Results"), and (4) the effect of increasing 1984 net income by $17.6 million as a result of the cumulative effect of a change in accounting method by LP&L to recognize unbilled revenues.

AFUDC for 1986 was approximately $8 million, a decrease of $356 million, or 97.7 percent, from 1985 and a decrease of $529 million, or 98.5 percent, from 1984. AFUDC currently represents slightly under 2 percent of net income. The dramatic reduction in AFUDC occurred because the System is no longer investing large sums in construction now that Grand Gulf 1 and Waterford 3 are in service and because of the suspension of construction on Grand Gulf 2 in September 1985.

Earnings per share on MSU common stock increased to $2.21, up from the $2.01 recorded in 1985 but down from the 1984 amount of $2.86. The 1986 increase reflects the previously mentioned increases in net income and only a slight increase of 2.5 percent in the average number of shares outstanding in 1986 over 1985.

Electric operating revenues increased by $254 million, or 8.2 percent, in 1986 compared with an increase of $125 million, or 4.2 percent, in 1985. The 1986 increase was due primarily to rate relief obtained by the System operating companies for their Grand Gulf 1-related costs, and in LP&L's case, its Waterford 3-related costs. In addition, an increase in energy sales to wholesale customers contributed to the increase in electric operating revenues. Partially offsetting the effects of rate relief were lower revenues resulting from recovery of lower fuel costs. The 1985 increase was due primarily to sales to non-associated utilities resulting from an off-peak contract for the sale of electricity between certain of the System operating companies and Gulf States Utilities.

As a result of a severe heat wave throughout the region in July 1986, the System experienced a record peak in demand for electricity of 11,697 megawatts, exceeding last year's peak demand by 7.6 percent. Despite this record peak demand, energy sales to retail customers in 1986 decreased 2.1 percent from 1985. The 1985 increase over 1984 was minimal. Residential sales increased 2.2 percent and 4.2 percent, respectively, in 1986 and 1985. Sales to commercial customers continued its increasing trend as reflected by increases of 2.7 percent and 6.8 percent in 1986 and 1985, respectively. Industrial sales decreased 8.2 percent in 1986 and 5.7 percent in 1985 reflecting a reduced level of aluminum processing by a major industrial customer during both 1986 and 1985 and a slowdown in the oil drilling and exploration industry during 1986.

Energy sales to wholesale customers increased 2,643 million kwh, or 52.5 percent, in 1986 compared with an increase of 3,178 million kwh, or 171.5 percent, in 1985. The 1986 increase reflects an increase in sales to municipalities and cooperatives along with the continuation of an increase in sales to non-associated utilities which began in 1985.

Gas operating revenues decreased $7.0 million, or 4.4 percent, in 1986 compared with a decrease of $33 million, or 17.6 percent, in 1985. Decreases for both years were due primarily to recovery of lower gas costs through the fuel adjustment clause and decreases in MCF sales of 2.2 percent and 16.4 percent, respectively, in 1986 and 1985. As a result of lower wholesale gas prices, gas purchased for resale declined 18.4 percent and 10.3 percent, respectively, in 1986 and 1985.

Fuel for electric generation declined $117 million, or 11.7 percent, from 1985. This decrease was due primarily to increased nuclear generation which is at a lower average unit price than other types of generation, and to a general decline in unit prices for other fuel types.

Purchased power expenses in 1986 declined $102 million, or 44.3 percent, compared with a decrease of $61 million, or 20.9 percent, in 1985. Such decreases were due primarily to the use of nuclear generating capacity provided by Grand Gulf 1 and Waterford 3 (which began commercial operation in July 1985 and September 1985, respectively), rather than the buying of power from companies outside the Middle South System.

In connection with their respective

rate moderation plans, the System operating companies deferred for future recovery through rates certain operating expenses totaling $786 million and $237 million, respectively, in 1986 and 1985. By deferring these costs associated with the rate moderation plans to the future when revenues are scheduled to be collected through increased rates billed to customers, the impact of the deferral aspect of these plans on the income statement has been removed. Because the actual collection of revenues to recover the deferred costs will not occur until the future, the rate moderation plans result in additional capital requirements, as discussed earlier under Liquidity and Capital Resources. In most cases, costs associated with financing such operating expenses during the period of such deferrals are recovered currently from customers.

Other operating expenses (exclusive of deferred fuel) increased $123 million, or 20.6 percent, in 1986 and $175 million, or 41.5 percent, in 1985. The 1986 increase was due primarily to additional nuclear production expenses, exclusive of nuclear fuel expenses, associated with the commercial operation of Grand Gulf 1 and Waterford 3. The 1985 increase was due primarily to the previously mentioned recording of provisions for estimated losses as of December 1985 associated with indefinitely delayed future fossil generating facilities and with certain investments in the System's fuel procurement program.

Maintenance expense increased $66 million, or 37.4 percent, in 1986 compared with an increase of $15 million, or 9.2 percent, in 1985. The 1986 increase was due primarily to the impact of a full year of maintenance expense associated with Grand Gulf 1 and Waterford 3.

Depreciation expense increased $81 million, or 30.5 percent, in 1986 compared with an increase of $73 million, or 38.0 percent, in 1985. These increases were due primarily to the recording of additional depreciation expense in connection with the commercial operation of Grand Gulf 1 and Waterford 3.

Total income tax expense increased $366 million, or 234.1 percent, in 1986 compared with an increase of $84 million, or 115.8 percent, in 1985. The 1986 increase was due primarily to an increase in pre-tax book income recorded by LP&L and SERI as a result of the commercial operation of Waterford 3 and Grand Gulf 1, respectively. The 1985 increase was the result of SERI recording additional income tax expense and reducing income tax credits in connection with the commercial operation of Grand Gulf 1.

Miscellaneous income and deductions-net decreased $4 million, or 4.6 percent, in 1986, compared with an increase of $62 million, or 342.9 percent, in 1985. The 1985 increase was due primarily to (1) an increase in interest income on temporary cash investments, (2) income associated with the capitalization of a deferred return on excess capacity provided by AP&L's Grand Gulf 1 settlement, (3) interest income associated with the settlement of AP&L's 1981 retail rate case, and (4) the gain recognized on the sale of a gas pipeline system by MP&L.

Interest on long-term debt showed a slight decrease of $5 million, or 0.7 percent, in 1986 compared with an increase of $61 million, or 9.7 percent, in 1985. The change in long-term debt during 1986 was minimal as most of the financings effected were in connection with the refunding and redemption of outstanding indebtedness. The 1985 increase was due to increasing amounts of long-term debt outstanding.

Other interest-net decreased $19 million, or 35.1 percent, in 1986 compared with a decrease of $4 million, or 7.1 percent, in 1985. The 1986 decrease reflects a reduction in the amount of short-term borrowings and in interest rates on such borrowings. The 1985 decrease was due primarily to lower interest rates.

Effect of Inflation

In December 1986, the FASB issued SFAS No. 89 which rescinded the requirement to provide certain supplementary information concerning the effect of changing prices on the System. This information, which was presented in previous years as a note to the consolidated financial statements, has been deleted from this year's report. The System's operations were not significantly affected by inflation during the period 1984-1986. In the future, should high levels of inflation occur, the System's operations could be adversely affected if timely and adequate rate relief is not received.

Summary

The Middle South System experienced a modest improvement in its financial condition during 1986. Several uncertainties, which had the potential to impede the System's financial recovery, were moderated during late 1986 and early 1987. However, other significant uncertainties continue to face the System. These include: (1) challenges to and/or potential reversals of rate orders and settlements, (2) appeals of the ruling affirming the June 13 decision, (3) ongoing prudence investigations, (4) ongoing deliberations with respect to the accounting for phase-in plans, and (5) various takeover threats.

The ability of the Middle South System to continue its financial recovery depends primarily upon the continuing effectiveness of the retail rate structures implemented in 1985 and 1986 for the recovery of costs associated with Grand Gulf 1 and Waterford 3. Certain of the retail rate structures are the subject of challenge and one has been reversed by the Mississippi Supreme Court subject to appeal to the United States Supreme Court. Should one or more of these rate structures cease to be in effect, the Middle South System would be materially and adversely affected. (See Note 2 to the Consolidated Financial Statements—"Rate and Regulatory Matters" and Note 8 to the Consolidated Financial Statements—"Commitments and Contingencies.")

Consolidated Balance Sheets

Middle South Utilities, Inc. & Subsidiaries

December 31	1986	1985
	(In thousands)	
Assets		
Utility Plant (Notes 1, 8, and 9):		
Electric	$12,814,990	$12,580,087
Natural gas	130,488	125,189
Construction work in progress	282,747	1,127,370
Nuclear fuel	241,812	311,092
Total	13,470,037	14,143,738
Less—Accumulated depreciation and amortization	2,395,523	2,080,838
Utility plant—net	11,074,514	12,062,900
Other Property and Investments	74,095	57,964
Current Assets:		
Cash and special deposits (Note 4)	34,972	26,419
Temporary investments—at cost, which approximates market (Note 11)	542,427	526,293
Notes receivable	1,669	2,585
Accounts receivable:		
Customer (less allowance for doubtful accounts of [in thousands] $7,825 in 1986 and $4,976 in 1985)	174,209	191,837
Other	26,384	34,583
Accrued unbilled revenues (Note 1)	54,973	54,218
State income taxes receivable (Note 3)	20,750	8,586
Accumulated deferred income taxes (Note 3)	—	67,982
Fuel inventory (Notes 1 and 4)	93,366	119,543
Materials and supplies—at average cost	90,459	79,105
Rate deferrals (Notes 1, 2, and 8)	24,398	23,936
Prepayments and other	66,999	41,682
Total	1,130,606	1,176,769
Deferred Debits:		
Rate deferrals (Notes 1, 2, and 8)	998,909	218,808
Suspended construction project (Notes 1 and 8)	908,572	—
Other	171,835	148,596
Total	2,079,316	367,404
Total	$14,358,531	$13,665,037

See Notes to Consolidated Financial Statements.

	1986	1985
	(In thousands)	
Capitalization and Liabilities		
Capitalization:		
Common stock, $5 par value, authorized 250,000,000 shares; issued and outstanding 204,581,092 shares	$ 1,022,905	$ 1,022,905
Paid-in capital	1,565,889	1,567,866
Retained earnings (Note 7)	1,765,632	1,316,388
Total common shareholders' equity	4,354,426	3,907,159
Subsidiaries' preferred stock (Note 5):		
Without sinking fund	330,967	330,967
With sinking fund	508,165	467,293
Long-term debt (Notes 6 and 8)	5,983,029	5,680,590
Total	11,176,587	10,386,009
Other Noncurrent Liabilities (Note 1)	60,146	53,820
Current Liabilities:		
Notes payable (Notes 4 and 8):		
Banks	—	124,160
Commercial paper	105,000	125,000
Other	31,000	49,135
Currently maturing long-term debt (Notes 4 and 6)	318,854	609,380
Accounts payable	280,191	362,498
Gas contract settlements—liability to customers (Note 11)	254,446	224,728
Deferred fuel cost	26,314	39,045
Customer deposits	64,934	62,295
Taxes accrued	66,363	82,746
Accumulated deferred income taxes (Note 3)	21,073	—
Interest accrued	170,542	164,737
Preferred dividends	22,220	35,961
Other	89,604	72,895
Total	1,450,541	1,952,580
Deferred Credits:		
Accumulated deferred income taxes (Note 3)	1,121,277	648,918
Accumulated deferred investment tax credits (Note 3)	60,577	65,740
Gas contract settlement—liability to customers (Note 11)	338,076	412,323
Other	151,327	145,647
Total	1,671,257	1,272,628
Commitments and Contingencies (Notes 1, 2, 8, and 9)		
Total	$14,358,531	$13,665,037

Statements of Consolidated Income

Middle South Utilities, Inc. & Subsidiaries

For the years ended December 31	1986	1985	1984
		(In thousands)	
Operating Revenues:			
Electric	$3,339,132	$3,084,877	$2,959,570
Natural gas	146,780	153,582	186,465
Total	3,485,912	3,238,459	3,146,035
Operating Expenses:			
Operation:			
Fuel for electric generation	884,560	1,001,373	1,020,280
Purchased power	128,405	230,399	291,129
Gas purchased for resale	98,337	120,542	134,420
Deferred fuel and other	703,153	593,571	465,713
Maintenance	242,261	176,293	161,433
Depreciation	346,361	265,500	192,452
Taxes other than income taxes	161,042	132,759	110,799
Income taxes (Note 3)	162,265	121,402	216,395
Rate deferrals:			
Rate deferrals (Notes 1, 2, and 8)	(785,897)	(236,676)	—
Income taxes (Note 3)	383,180	117,245	—
Total	2,323,667	2,522,408	2,592,621
Operating Income	1,162,245	716,051	553,414
Other Income:			
Allowance for equity funds used during construction (Note 1)	8,830	217,734	301,123
Miscellaneous income and deductions—net	76,403	80,120	18,090
Income taxes—credit (Note 3)	22,645	82,166	160,442
Total	107,878	380,020	479,655
Interest and Other Charges:			
Interest on long-term debt	692,980	697,853	636,390
Other interest—net	34,608	53,306	57,388
Allowance for borrowed funds used during construction (Note 1)	590	(146,680)	(235,873)
Preferred dividend requirements of subsidiaries	90,643	90,601	84,353
Total	818,821	695,080	542,258
Income Before Cumulative Effect of a Change in Accounting Method	451,302	400,991	490,811
Cumulative Effect to January 1, 1984, of Accruing Unbilled Revenues (net of income taxes of $16,548 thousand) (Note 1)	—	—	17,626
Net Income	$ 451,302	$ 400,991	$ 508,437
Earnings Per Average Common Share:			
Before cumulative effect of a change in accounting method	$2.21	$2.01	$2.76
Cumulative effect to January 1, 1984, of accruing unbilled revenues—net	—	—	0.10
Total	$2.21	$2.01	$2.86
Dividends Declared Per Common Share	—	$0.89	$1.75
Average Number of Common Shares Outstanding	204,581,092	199,496,115	178,083,867

See Notes to Consolidated Financial Statements.

Statements of Consolidated Retained Earnings and Paid-in Capital

Middle South Utilities, Inc. & Subsidiaries

For the years ended December 31	1986	1985	1984
		(In thousands)	
Retained Earnings			
Retained Earnings, January 1	$1,316,388	$1,090,839	$ 899,979
Add—Net income	451,302	400,991	508,437
Total	1,767,690	1,491,830	1,408,416
Deduct:			
Dividends declared on common stock—$0.89 and $1.75 per share for 1985 and 1984, respectively (Notes 7 and 8)	—	175,128	315,811
Capital stock and other expenses	2,058	314	1,766
Total	2,058	175,442	317,577
Retained Earnings, December 31 (Note 7)	$1,765,632	$1,316,388	$1,090,839
Paid-in Capital			
Paid-in Capital, January 1	$1,567,866	$1,435,570	$1,271,152
Add:			
Excess of net proceeds over par value:			
Public sales of common stock:			
4,000,000 shares in 1985	—	36,404	—
9,200,000 shares in 1984	—	—	66,148
Common stock issued in connection with:			
Continuous offering program:			
3,452,000 shares in 1985	—	30,044	—
2,931,900 shares in 1984	—	—	23,361
Dividend reinvestment and stock purchase plan:			
7,642,772 shares in 1985	—	62,280	—
10,253,270 shares in 1984	—	—	67,751
Employee savings plan:			
318,992 shares in 1985	—	2,742	—
539,229 shares in 1984	—	—	4,146
Employee stock ownership plan:			
160,801 shares in 1984	—	—	1,246
Other	(1,977)	826	1,766
Paid-in Capital, December 31	$1,565,889	$1,567,866	$1,435,570

See Notes to Consolidated Financial Statements.

Statements of Changes in Consolidated Financial Position

Middle South Utilities, Inc. & Subsidiaries

For the years ended December 31	1986	1985	1984
		(In thousands)	
Funds Provided By:			
Operations:			
Net income (1984 includes $17.6 million special item [Note 1])	$ 451,302	$ 400,991	$ 508,437
Depreciation	346,361	265,500	192,452
Deferred income taxes and investment tax credit adjustments—net	556,223	150,223	50,867
Write-off of deferred costs relating to standard coal plant design and equipment	31,657	16,790	—
Write-off of deferred costs relating to SFI's fuel acquisition program	19,151	—	—
Allowance for equity funds used during construction (Note 1)	(8,830)	(217,734)	(301,123)
Provision for losses	13,978	52,707	—
Total funds provided by operations	1,409,842	668,477	450,633
Other:			
Allowance for equity funds used during construction (Note 1)	8,830	217,734	301,123
Gas contract settlements (Note 11)	11,846	186,151	247,526
Decrease in working capital*	—	—	25,581
Miscellaneous—net	—	20,827	16,220
Total funds provided excluding financing transactions	1,430,518	1,093,189	1,041,083
Financing and other transactions:			
Common stock	—	208,539	278,079
Preferred stock	85,000	—	65,000
First mortgage bonds	1,750,000	130,000	625,000
Bank notes and other long-term debt	427,846	446,684	399,094
Sale and leaseback of nuclear fuel	143,998	54,045	36,157
Obligations under capital leases and an inventory supply agreement	29,233	3,023	4,164
Short-term securities—net	—	156,348	—
Total funds provided by financing and other transactions	2,436,077	998,639	1,407,494
Total funds provided	$3,866,595	$2,091,828	$2,448,577
Funds Applied To:			
Utility plant additions:			
Construction expenditures for utility plant	$ 335,289	$ 876,473	$1,298,858
Nuclear fuel	74,718	64,225	124,545
Capital leases	1,773	4,021	5,000
Total gross additions (includes allowance for funds used during construction)	411,780	944,719	1,428,403
Rate deferrals (Notes 1, 2, and 8)	780,563	242,744	—
Other:			
Dividends declared on common stock (Notes 7 and 8)	—	175,128	315,811
Increase in working capital*	105,232	38,213	—
Gas contract settlements (Note 11)	68,221	249,117	20,018
Deferred costs relating to standard coal plant design	10,743	60,389	—
Miscellaneous—net	49,890	—	—
Total other funds applied	234,086	522,847	335,829
Financing transactions:			
Retirement of bank notes and other long-term debt	1,352,912	298,070	95,149
Retirement of first mortgage bonds	825,630	73,600	80,865
Redemption of preferred stock	40,961	9,848	16,195
Unamortized premium on reacquired debt	34,918	—	—
Funds held in escrow	19,162	—	—
Short-term securities—net	166,583	—	492,136
Total funds applied to financing transactions	2,440,166	381,518	684,345
Total funds applied	$3,866,595	$2,091,828	$2,448,577
***Increase (Decrease) in Working Capital:**			
Cash and special deposits	$ 8,553	$ (3,461)	$ 8,031
Receivables	(13,824)	65,862	5,323
Fuel inventory	(26,177)	(33,237)	42,704
Accounts payable	82,307	(119,906)	28,799
Deferred fuel cost	12,731	4,266	(47,009)
Interest and taxes accrued	10,578	41,861	(51,803)
Dividends declared	13,741	68,532	(11,910)
Other current assets and liabilities	17,323	14,296	284
Total	$ 105,232	$ 38,213	$ (25,581)

*Working capital excludes the following current assets and liabilities: temporary investments, rate deferrals, deferred income taxes, notes payable, currently maturing long-term debt, and the gas contract settlements.

See Notes to Consolidated Financial Statements.

Notes to Consolidated Financial Statements

Middle South Utilities, Inc. & Subsidiaries

Note 1. Summary of Significant Accounting Policies

A. Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Middle South Utilities, Inc. (the Company or MSU) and its direct and indirect subsidiaries, Arkansas Power & Light Company (AP&L), Louisiana Power & Light Company (LP&L), Mississippi Power & Light Company (MP&L), New Orleans Public Service Inc. (NOPSI), MSU System Services, Inc. (SSI) (formerly Middle South Services, Inc.), System Energy Resources, Inc. (SERI) (formerly Middle South Energy, Inc.), System Fuels, Inc. (SFI), and Electec, Inc. The above companies, excluding Electec, Inc., are collectively referred to as the System companies or the Middle South System. All significant intercompany transactions have been eliminated except as allowed by Statement of Financial Accounting Standards (SFAS) No. 71.

B. Systems of Accounts

The accounts of the Company and its service subsidiary, SSI, are maintained in accordance with the Public Utility Holding Company Act of 1935 (Holding Company Act), as administered by the Securities and Exchange Commission (SEC), which has adopted a system of accounts consistent with the system of accounts prescribed by the Federal Energy Regulatory Commission (FERC).

The accounts of the System operating companies (AP&L, LP&L, MP&L, and NOPSI) are maintained in accordance with the systems of accounts prescribed by the applicable regulatory bodies, which systems of accounts substantially conform to those prescribed by the FERC. The accounts of the generating subsidiary, SERI, are maintained in accordance with the system of accounts prescribed by the FERC. The accounts of the non-utility subsidiary, Electec, Inc., are maintained in accordance with the system of accounts prescribed by the SEC.

C. Revenues and Fuel Costs

Three of the operating subsidiaries record electric and gas revenues as billed to their customers on a cycle billing basis. Revenues are not accrued for energy delivered but not yet billed by the end of the fiscal period. Substantially all of the rate schedules of the operating subsidiaries include adjustment clauses under which the cost of fuel used for generation and gas purchased for resale above or below specified base levels is permitted to be billed or required to be credited to customers.

Prior to January 1, 1984, LP&L recognized revenue when billed. To provide a better matching of LP&L's revenues and expenses, effective January 1, 1984, LP&L adopted, in March 1984, a change in accounting method to provide for accrual of the non-fuel portion of estimated unbilled revenues. Unbilled revenues result from energy delivered since the period covered by the latest billings to customers. The cumulative effect of this accounting change as of January 1, 1984, was recorded in March 1984 and increased 1984 net income approximately $17.6 million (net of related income taxes of $16.5 million).

MP&L has a fuel adjustment clause which allows current recovery of fuel costs. The three other operating subsidiaries utilize a deferral method of accounting for those fuel costs recoverable under fuel adjustment clauses. Under this method, such costs are deferred until the related revenues are billed.

The fuel adjustment factor for AP&L contains an amount for a nuclear reserve estimated to cover the cost of replacement energy when the nuclear plant is down for scheduled maintenance and refueling. The reserve bears interest and is used to reduce fuel expense for fuel adjustment purposes during the shutdown period.

D. Utility Plant and Depreciation

Utility plant is stated at original cost. The cost of additions to utility plant includes contracted work, direct labor and materials, allocable overheads, and an allowance for the composite cost of funds used during construction. The cost of units of property retired are removed from utility plant and such costs, plus removal costs, less salvage, are charged to accumulated depreciation. Maintenance and repairs of property and replacement of items determined to be less than units of property are charged to operating expenses.

Depreciation is computed on the straight-line basis at rates based on the estimated service lives of the various classes of property. However, depreciation on Unit 1 of the Grand Gulf Station (Grand Gulf 1) was computed on the units of production method for the initial twelve months of commercial operation (which began July 1, 1985) and, with FERC approval, for an additional six months thereafter. Subsequent to December 31, 1986, depreciation will be computed on a straight-line basis. SERI has filed an application with the FERC to determine the appropriate depreciation rate for Grand Gulf 1. Depreciation rates for LP&L's Waterford 3 Nuclear Station (Waterford 3) and for AP&L's nuclear station include a provision for nuclear plant decommissioning costs. Depreciation provisions on average depreciable property approximated 2.7%, 2.9%, and 3.3% in 1986, 1985, and 1984, respectively.

Substantially all of the System's utility plant is subject to the liens of the subsidiaries' first mortgage bond indentures.

E. Rate Deferrals

The System operating companies had in effect in 1985 and/or 1986 various rate moderation or phase-in plans in order to reduce the immediate effect on ratepayers of the inclusion of Grand Gulf 1 and Waterford 3 costs in rates. Under these plans, certain costs are either permanently retained (and not recovered from ratepayers), deferred in the early years of commercial operation and collected in the later years, or recovered currently from customers. These plans vary both in the proportions of costs that each company retains, defers, or recovers and in the length of the deferral/recovery periods. By deferring costs associated with the rate moderation plans to the future when they will be collected through increased rates billed to customers, the impact of the deferral aspect of these plans on the income statement has been removed. Only those costs permanently retained

Notes to Consolidated Financial Statements

Middle South Utilities, Inc. & Subsidiaries

and not recovered through rates or through sales to third parties result in a reduction of net income. Because the actual collection of revenues to recover the deferred costs will not occur until the future, each company records a deferred asset representing the amount of the deferrals and, at the same time, incurs additional capital requirements to finance these deferrals. The recording of these deferred costs as assets is based on the probability of the regulator allowing the recovery of these costs in future rates. In most cases, the carrying charges associated with the financing of the deferrals are recovered currently from customers.

F. Postretirement Benefits

The Company and its subsidiaries have various defined postretirement benefit plans covering substantially all of their employees. The policy of the Company and its subsidiaries has been to fund pension costs accrued, but in certain cases in order to conserve cash, pension costs have been funded in accordance with contribution guidelines established by the Employee Retirement Income Security Act of 1974. Other postretirement plan costs are funded as incurred.

G. Income Taxes

The Company and its subsidiaries file a consolidated Federal income tax return. Income taxes are allocated to all subsidiaries based on their contributions to the consolidated taxable income. Deferred income taxes are provided for differences between book and taxable income to the extent permitted by the regulatory bodies for ratemaking purposes. Investment tax credits utilized are deferred and amortized based upon the average useful life of the related property.

H. Allowance for Funds Used During Construction

To the extent that the Company's operating subsidiaries are not permitted by their regulatory bodies to recover in current rates the carrying costs of funds used for construction, they capitalize, as an appropriate cost of utility plant, an allowance for funds used during construction (AFUDC) that is calculated and recorded as provided by the regulatory systems of accounts. Under this utility industry practice, construction work in progress on the balance sheet is charged and the income statement is credited for the approximate net composite interest cost of borrowed funds and for a reasonable return on the equity funds used for construction. This procedure is intended to remove from the income statement the effect of the cost of financing the construction program. It effectively results in treating the AFUDC charges in the same manner as construction labor and material costs in that each is capitalized rather than expensed. As non-cash items, these credits to the income statement have no effect on current cash earnings. After the property is placed in service, the AFUDC charged to construction costs is recoverable from customers through depreciation provisions included in rates for utility service.

For the period January 1, 1984, through March 1, 1984, LP&L used an accrual rate for AFUDC of 3% on $1.3 billion of construction costs in accordance with a May 1981 rate order from the Louisiana Public Service Commission (LPSC). Effective March 2, 1984, this accrual rate was changed by that commission to 3.5% on LP&L's investment in Waterford 3 up to an investment of $1.7 billion. The effective composite rates of the operating subsidiaries for the balance of AFUDC were 9.2%, 9.7%, and 9.5% for 1986, 1985, and 1984, respectively. Through June 30, 1985, SERI used an accrual rate for AFUDC based on a return on average common equity of 14%, plus actual interest costs net of related income taxes. As a result of the FERC's June 13, 1985 decision, SERI's 14% accrual rate for the equity component of AFUDC was increased to 16%, effective July 1, 1985. SERI's effective composite AFUDC rate was 10% for 1986.

The Company's subsidiaries continue to capitalize AFUDC on projects during periods of interrupted construction when such interruption is temporary and the continuation can be justified as being reasonable under the circumstances.

On September 18, 1985, the Mississippi Public Service Commission (MPSC) ordered SERI and MP&L to suspend construction of Grand Gulf 2 as of that date. Concurrent with the suspension of construction, SERI ceased accruing AFUDC on the unit effective September 18, 1985. (See Note 8—"Commitments and Contingencies—Grand Gulf 2" for further information.)

I. Other Noncurrent Liabilities

It is the policy of AP&L, LP&L, and NOPSI to provide provisions for uninsured property risks and for claims for injuries and damages through charges to operating expenses on an accrual basis. Accruals for these provisions, classified as other noncurrent liabilities, have been allowed for ratemaking purposes. Prior to January 1, 1985, MP&L had a similar policy regarding such provisions. However, to comply with a regulatory agreement, MP&L, effective January 1, 1985, suspended provisions for its uninsured property risks and claims for injuries and damages. Effective July 1, 1985, MP&L implemented a procedure to amortize, over a three-year period, the accumulated balances of such provisions as of June 30, 1985.

J. Inventories

Prior to January 1, 1986, all fuel inventories of the System were valued at average cost. In July 1986 SFI adopted, retroactive to January 1, 1986, the last-in, first-out (LIFO) valuation method for its fuel oil inventory in order to achieve a better matching of current market conditions with the cost of fuel oil it charges the System operating companies. This change in valuation method did not have a material effect on the amounts charged to such companies.

K. Reclassifications

Certain reclassifications of previously reported amounts have been made to conform with current classifications. Due to the continued suspension of construction on Grand Gulf 2 through 1989 or beyond, the total costs to date of construction on the unit were reclassified in December 1986 from utility plant—construction work in progress to deferred debits—suspended construction project. (See Note 8—"Commitments and Contingencies—Grand Gulf 2.") These reclassifications had no effect on net income.

Note 2.
Rate and Regulatory Matters

Decisions Rendered

On January 30, 1987, the LPSC issued a permanent rate order granting LP&L a rate increase of $76.2 million annually with respect to Waterford 3. This amount was in addition to the rate increases resulting from the LPSC's November 1985 emergency interim rate order. The LPSC also ordered LP&L to make no further refunds to its jurisdictional customers of the proceeds of a gas contract settlement of approximately $386 million and to use these funds to offset the accumulated Waterford 3 revenue deferral of approximately $247 million as of January 31, 1987. The remainder of the proceeds will be used as a rate base reduction. This permanent rate order further stated that there would be no need for a multi-year phase-in plan for Waterford 3 as originally proposed in the interim order. Moreover, the LPSC stated that prudence issues associated with Grand Gulf 1, Waterford 3, and LP&L's management would not be resolved in this order. LP&L has not decided whether to appeal the order. Several intervenors have filed with the LPSC motions for rehearing and for stay of the January 30, 1987 order. The matter is pending.

As part of the November 1985 interim rate order, LP&L agreed to permanently absorb $284 million of Waterford 3 costs. It was also decided at that time that any disallowance resulting from a prudence investigation would be limited to the amount by which the imprudent investment exceeds $284 million . On October 22, 1986, the consultants retained by the LPSC to investigate the prudence issues made public their report in which they concluded that a total of $143 million in expenditures were imprudently incurred on Waterford 3. It is the position of LP&L that none of the costs were imprudently incurred. The report also concluded that the decisions to build Waterford 3 and Grand Gulf 1 were reasonable.

On March 25, 1986, NOPSI accepted an offer of settlement from the New Orleans City Council (Council) with respect to permanent rate relief for Grand Gulf 1. The settlement provides, among other things, for NOPSI to currently recover certain portions of its non-fuel Grand Gulf 1-related costs; to defer a portion of such costs for future recovery through a phase-in plan; and to permanently absorb a total of $51.2 million in previously unrecovered Grand Gulf 1 non-fuel related costs. Other terms and conditions of the settlement include NOPSI's agreement not to request any non-Grand Gulf electric rate increase to take effect prior to January 1, 1988, and the agreement between NOPSI and the Council to allow the Council to continue with its inquiry into the prudence of NOPSI's involvement in the Grand Gulf Station. In conjunction with the prudence inquiry, the Council may attempt to take action to force NOPSI to absorb additional costs associated with Grand Gulf 1. NOPSI would vigorously oppose any such action by the Council through the courts.

Decisions Pending

On July 11, 1986, LP&L filed with the Council, with respect to the 15th Ward of the City of New Orleans, a general retail rate increase application to reflect costs associated with Grand Gulf 1, to reflect the in-service status of Waterford 3, and to produce a just and reasonable rate of return. The application is pending. On February 19, 1987, the Council adopted a resolution ordering an investigation of LP&L's prudence in connection with construction of Waterford 3.

Other Rate Matters

On August 28, 1986, the Arkansas Public Service Commission (APSC) approved a revised rate rider filed by AP&L with respect to the Grand Gulf Settlement Agreement and also approved, with certain modifications, a new tax adjustment rate rider filed by AP&L to reflect the reduction in the corporate income tax rate as provided by the Tax Reform Act of 1986. The concurrent implementation of these riders results in a net decrease in revenues of approximately $21.3 million, which is applicable to the period September 1, 1986, to August 31, 1987.

On September 16, 1985 the MPSC issued an order establishing a multi-year phase-in plan allowing recovery by MP&L of its payments to SERI in respect of costs associated with Grand Gulf 1. This order was appealed to the Mississippi Supreme Court by the Mississippi Attorney General and the Mississippi Legal Services Coalition. On February 25, 1987, the Mississippi Supreme Court rendered a decision reversing and remanding the rate case to the MPSC for further proceedings not inconsistent with the Court's opinion. The Supreme Court found reversible error in the MPSC's September 16, 1985 order on the grounds that the MPSC (1) adopted retail rates to pay Grand Gulf 1 expenses without first determining that the expenses were prudently incurred, (2) failed to join MSU and SERI as parties to the rate proceeding, and (3) should not have allowed intervention in the proceeding by security holders of MSU. MSU and SERI have intervened in the Mississippi Supreme Court appeal. MP&L continues to collect the rates approved by the MPSC in its September 16, 1985 order, which rates are subject to refund to the extent that a final judicial determination may result in a schedule of rates less than what the MPSC allowed. MP&L has requested a stay from the Mississippi Supreme Court decision pending appeal to the U.S. Supreme Court. MP&L may be required to post a bond in connection with the continuation of the appellate process which could be significant and may not be able to be obtained. If a stay is not granted and the September 16, 1985 order is determined to not be in effect, or if the stay is granted and a final judicial determination is materially adverse to MP&L's interest, MP&L's earnings, liquidity, and financial condition and its ability to meet its ongoing obligations would be severely impaired, and MP&L could be rendered insolvent. Through February 28, 1987, MP&L had collected approximately $160 million under the September 16, 1985 order and had deferred approximately $395 million of its allocable share of Grand Gulf 1 expenses, based upon provisions in the plan allowing for future recovery of such amounts.

On September 16, 1986, the MPSC issued an order that would have blocked an increase in MP&L's rates scheduled to go into effect in the second year of MP&L's phase-in plan associated with Grand Gulf 1. On September 19, 1986, the MPSC withdrew the September 16 order and allowed the Grand Gulf 1 second year phase-in rate to go into effect. Concurrently, MP&L filed a temporary rate reduction rider which reduced revenue requirements in other areas by an amount equivalent to the additional Grand Gulf revenue, totaling about $41 million annually. MP&L expects, however, that this temporary reduction in base rates will be partially offset by a reduction in certain of its expenses.

Regulatory Matters

On June 13, 1985, the FERC issued a decision in the Unit Power Sales Agreement and System Agreement proceedings (June 13 Decision). The June 13 Decision, among other things, allocated the capacity and energy of SERI's 90% share of Grand Gulf 1 to the System operating companies, granted SERI a 16% rate of return on common equity, and adopted a 16% rate of return on common equity under the System Agreement. Various parties, including AP&L and MP&L, filed appeals of the FERC rulings and some parties filed motions for a stay with the United States Court of Appeals for the District of Columbia Circuit. On January 6, 1987, the Court of Appeals affirmed the June 13 Decision. In its opinion, the Court of Appeals held, among other things, that the allocation of Grand Gulf 1 capacity and costs was within the FERC's jurisdiction; that state commissions may not interfere with the FERC's plenary power to allocate Grand Gulf 1 capacity and costs; and that the FERC's June 13 Decision "was both rational and within the Commission's range of discretion to remedy unduly discriminatory rates." Various parties have filed requests for rehearing with the Court of Appeals and petitions for certiorari to the United States Supreme Court.

On September 17, 1986, the LPSC sent to the FERC for filing a complaint against SERI alleging that the 16% rate of return on common equity under the Unit Power Sales Agreement authorized by the June 13 Decision has become an unjust and unreasonable rate. The complaint is seeking the reduction of such rate "to a just and reasonable level based on current conditions." Various parties have intervened in this proceeding. On January 27, 1987, the FERC denied SERI's motion to dismiss the complaint and ordered that hearings be held on the justness and reasonableness of such rate. Any change ordered by the FERC would be prospective only. The matter is pending.

On September 25, 1986, the LPSC sent to the FERC for filing a complaint against SSI, similar to the complaint discussed above, seeking a reduction in the FERC approved 16% rate of return on common equity under the System Agreement. Various parties have intervened in this proceeding. On January 27, 1987, the FERC consolidated this proceeding with that of the above mentioned proceeding investigating SERI's return on equity. The matter is pending.

On September 16, 1986, the MPSC issued an order establishing a docket for the stated purposes, among other things, of examining the prudence of actions of MP&L and/or SERI relating to the construction and operation of the Grand Gulf Station and the appropriate regulatory treatment of associated costs; obtaining FERC review of SERI's rate of return on common equity; obtaining FERC revision and/or modification of various aspects of MP&L's Grand Gulf 1 expenses established by the FERC, including the allocation of Grand Gulf 1 costs; inquiring generally into the appropriateness of MP&L's general rate structure; and performing a detailed audit of the books and records of SERI. Motions filed by MP&L and SERI to dismiss this docket were denied by the MPSC on January 28, 1987. On February 3, 1987, the MPSC issued an order in this docket directing SERI and MP&L to show cause why their Certificate of Public Convenience and Necessity relating to the Grand Gulf Station should not be cancelled for the failure of SERI and MP&L to allow the MPSC to audit the books and records of SERI. SERI had objected to the MPSC auditing its books and records on jurisdictional and other grounds. On February 23, 1987, South Mississippi Electric Power Association (SMEPA), owner of 10 percent of the Grand Gulf Station, filed a motion to intervene in the proceedings. On March 3, 1987, SMEPA's motion to intervene was granted. A hearing on the show cause order is scheduled for April 7, 1987. The ultimate outcome of these proceedings, including the show cause order, cannot be predicted.

Takeover Investigations

In connection with controversies surrounding the cost and allocation of capacity and energy from the Grand Gulf Station, various governmental bodies and officials have been investigating the possibility of condemning, expropriating, or otherwise acquiring electric utility properties of certain of the System operating companies. The Council is considering the acquisition by the City of New Orleans of the electric utility properties of NOPSI and those of LP&L in the 15th Ward of the City. The ordinances under which NOPSI operates state, among other things, that the City has a continuing option to purchase NOPSI's properties. On March 7, 1985, the Council established a public power authority for the purposes, among others, of acquiring and operating electric power utilities in the City of New Orleans. In addition, the governing body of the Parish of Jefferson, Louisiana has been studying the possible acquisition of LP&L's properties within that Parish.

In certain cases, government officials have expressed the view, with which the affected System operating companies do not agree, that a condemnation, expropriation or other acquisition of properties could be accomplished without the acquiring entity assuming responsibility for the related obligations of the particular System operating company, especially those relating to the purchase of capacity and energy from the Grand Gulf Station. NOPSI and LP&L believe that any such takeovers would not be in the best interests of their respective customers and investors, or the companies themselves, and would vigorously oppose any actual takeover attempts.

Note 3.
Income Taxes

Income tax expense (credit) consists of the following:

	1986	1985	1984
		(In thousands)	
Current:			
State	$(33,423)	$ 6,258	$ 21,634
Deferred—Net:			
Liberalized depreciation	271,674	139,421	73,394
Unbilled revenue	730	7,598	18,985
Rate deferrals	383,180	117,245	—
Deferred fuel cost	8,082	1,378	(22,775)
Other deferred nuclear power costs	11,091	11,238	—
Revenues subject to refund	(1,623)	2,594	(1,711)
Gas contract settlement	81,096	(82,133)	—
Loss on sale of fuel oil and nuclear fuel to third parties	3,171	17,779	—
Adjustment of prior years' tax provisions	(1,022)	(19,410)	—
Provision for estimated losses	1,040	(43,415)	—
Other	13,622	4,088	1,757
Reduction due to tax loss carryforwards	(209,799)	(1,461)	(15,277)
Total	561,242	154,922	54,373
Investment tax credit adjustments—net	(5,019)	(4,699)	(3,506)
Recorded income tax expense	$522,800	$156,481	$ 72,501
Charged to operations	$545,445	$238,647	$216,395
Credited to other income	(22,645)	(82,166)	(160,442)
Charged to cumulative effect of change in accounting method	—	—	16,548
Recorded income tax expense	522,800	156,481	72,501
Income taxes applied against the debt component of AFUDC	(3,157)	133,478	202,626
Total income taxes	$519,643	$289,959	$275,127

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

	1986		1985		1984	
	Amount	% of Pre-Tax Income	Amount	% of Pre-Tax Income	Amount	% of Pre-Tax Income
Computed at statutory rate	$489,783	46.0	$298,114	46.0	$306,034	46.0
Increases (reductions) in tax resulting from:						
AFUDC	(2,142)	(.2)	(164,999)	(25.5)	(245,742)	(36.9)
State income taxes net of Federal income tax effect	28,185	2.6	18,687	2.9	11,659	1.8
Depreciation	21,536	2.0	3,970	.6	805	.1
Other—net	(14,562)	(1.3)	709	.1	(255)	(.1)
Recorded income tax expense	522,800	49.1	156,481	24.1	72,501	10.9
Income taxes applied against the debt component of AFUDC	(3,157)	(.3)	133,478	13.0	202,626	20.8
Total income taxes	$519,643	48.8	$289,959	37.1	$275,127	31.7

The tax effects of the consolidated 1984, 1985, and 1986 Federal tax losses have been recorded as reductions of deferred income taxes. The remaining Federal tax loss carryforwards at December 31, 1986, amounted to $895.5 million and are available to offset taxable income in future years. If not used, they will expire in 1994 through 2000. Unused investment tax credits at December 31, 1986 amounted to $732.6 million before any reductions resulting from the Tax Reform Act of 1986. These credits may be applied against Federal income tax liabilities in future years. If not used, they will expire in 1992 through 2001.

Cumulative income tax timing differences for which deferred income tax expenses have not been provided are $480.7 million, $467.4 million, and $382.5 million in 1986, 1985, and 1984, respectively.

See Management's Financial Discussion and Analysis for a discussion of the Tax Reform Act of 1986 and its impact on the System.

Note 4. Lines of Credit and Related Borrowings

The Company had, during 1986, a revolving credit agreement with various banks providing for the issuance of unsecured bank notes totaling $25 million. On December 31, 1986, the Company entered into a new bank revolving credit agreement which provides for borrowings of up to $60 million and will terminate December 31, 1989. The Company pays a commitment fee on the unused portion of the credit line.

Prior to June 28, 1985, SERI had two revolving credit agreements with various banks providing for borrowings totaling $2,089 million. One agreement, for $1,711 million, was with U.S. Banks; the other agreement, with Foreign Banks, was for $378 million. On August 2, 1985, and August 9, 1985, respectively, the Foreign and U.S. Bank Loan Agreements were amended, effective as of June 28, 1985, to convert the borrowings thereunder to term loans. At December 31, 1986, SERI had outstanding borrowings of $473.2 million and $236.2 million, respectively, under the U.S. and Foreign Bank Loan Agreements. The loans with U.S. Banks have a maturity date of February 5, 1989, subject to mandatory semiannual payments of $125 million due on the first day of each March and September, with the unpaid balance due on the maturity date. A portion of these semiannual payments will be applied to an escrow account for the benefit of certain banks participating in the U.S. Bank Loan Agreement that provided a letter of credit in connection with SERI's Series C Pollution Control Revenue Bonds. The uncollateralized amount needed to fund the escrow account was approximately $215.4 million at December 31, 1986. The maturity date for the loans with Foreign Banks is February 5, 1989, subject to mandatory semiannual payments of $47.25 million to be made on February 5 and August 5 of each year.

In March 1986, the Foreign Bank Loan Agreement was amended to (1) increase the interest rate on borrowings thereunder by 1% effective from February 5, 1986, and (2) change certain provisions of the Foreign Bank Loan Agreement relating to Grand Gulf 2 such that prepayment of outstanding borrowings under this agreement would not be required for condemnation, abandonment or noncompletion of Grand Gulf 2. These amendments relating to Grand Gulf 2 became effective in June 1986 when SERI paid to the Foreign Banks the deferred payments discussed below as well as the $47.25 million payment due to the Foreign Banks on August 5, 1986.

In March 1986, the U.S. and Foreign Banks allowed SERI to defer to June 1986, $268.1 million of scheduled payments due in February and March 1986. On June 5, 1986, SERI paid the $215.8 million remaining principal balance due of these deferred amounts. In addition, on June 30, 1986, SERI prepaid the $47.25 million semiannual payment due August 5, 1986 under the Foreign Bank Loan Agreement and the $125 million semiannual payment due September 1, 1986 under the U.S. Bank Loan Agreement. In September 1986, SERI prepaid $628.2 million of bank notes outstanding under the U.S. Bank Loan Agreement.

In January 1987, SERI prepaid $52.82 million of bank notes under the U.S. Bank Loan Agreement and $15 million under the Foreign Bank Loan Agreement. In addition, SERI paid in February 1987 the $47.25 million semiannual payment due under the Foreign Bank Loan Agreement. On March 1, 1987, SERI paid the scheduled semiannual installment due under the U.S. Bank Loan Agreement.

SERI has separate "interest rate swap" agreements, each with a bank, through February 1989 for $105.0 million and $131.3 million, respectively, (as of December 31, 1986) of the amounts outstanding under the Foreign Bank Loan Agreement. SERI has agreed to make semiannual interest payments based upon an 11.5% and an 11.16% fixed rate, respectively, in exchange for semiannual interest payments by the banks based upon the London Interbank Offered Rate (LIBOR). These agreements serve to offset fluctuations in variable rates to be paid under SERI's Foreign Bank Loan Agreement. They do not change SERI's obligations to the Foreign Banks for interest payments of LIBOR plus 2%.

The System operating companies are currently authorized by the SEC to effect short-term borrowings in an aggregate amount outstanding at any one time of up to 10% of their respective capitalizations. The operating subsidiaries have lines of credit, not requiring commitment fees, providing for short-term borrowings through loans from banks within their service territory. At December 31, 1986, LP&L had available and unused bank lines of credit of $110.0 million with banks located outside of the Middle South System service area. Compensating balances (approximately 5% of the commitment amount) or equivalent fees are required by certain of these non-service area lending banks. These compensating balances are not restricted as to withdrawal. In addition, NOPSI has a $30 million revolving credit agreement with an institutional lender under which borrowings are to be secured by a security interest in or lien upon accounts receivable of NOPSI. SERI is subject to limitations on the maximum amount of short-term borrowings outstanding under both the Holding Company Act and the terms of its credit arrangements. At December 31, 1986, the maximum permitted was the lesser of 5% of capitalization or $200 million. However, at December 31, 1986, SERI had no sources of short-term borrowings.

Additionally, the four System operating companies, together with MSU, SERI, SSI, and SFI, are authorized to participate in a System money pool, whereby those companies in the System with available funds can invest in the pool while other companies in the System (except MSU) having short-term needs can borrow from the pool, thereby reducing the System's dependence on external short-term borrowings. Prior to 1987, SERI participated only as a lender/investor in the money pool. Effective January 1, 1987, SERI received authorization from the SEC to borrow from the money pool subject to its maximum authorized level of short-term borrowings. The maximum borrowing and average borrowing by participants from the System money pool during 1986 were $105.8 million and $40.6 million, respectively. At December 31, 1986, System money pool borrowings were $26.2 million. In addition, SSI has a line of credit with MSU for $30 million through December 31, 1987.

At December 31, 1986, SFI had a fuel oil financing arrangement allowing for borrowings of up to $50 million subject to a limit equivalent to the lower of the cost or the fair market value of SFI's fuel oil inventory and certain related receivables. On January 1, 1987, this arrangement was reduced to $40 million. SFI's borrowings under this fuel oil financing arrangement were $26.0 million at year end. In addition, at December 31, 1986, SFI had two arrangements to borrow up to $105 million in the aggregate through the sale of commercial paper for use in financing its nuclear fuel inventory. On February 1, 1987, after one of these arrangements was reduced, this amount totaled $85 million. The reduced arrangement, which totaled $20 million at February 1, 1987, will be allowed to terminate in April 1987. Borrowings under these short-term arrangements are restricted as to use and are secured by SFI's fuel oil inventory and a portion of its nuclear fuel inventory, respectively, and certain accounts receivable arising from the sale of these inventories. SFI also has a revolving bank credit agreement which allows for borrowings of up to $15 million through December 31, 1987 and is secured by its oil and gas properties. A commitment fee is paid on the unused portion of this commitment. Further, SFI has a secured revolving credit agreement to finance, in part, its nuclear fuel inventory, which allows for borrowings of up to $50 million through April 10, 1989. It is currently contemplated that the above financing arrangements, which are scheduled to terminate during the period 1987-1989, will, with the exception of the arrangement terminating in April 1987, be extended if necessary or alternative financing arrangements will be secured.

The short-term borrowings (excluding money pool borrowings) and the interest rates (determined by dividing applicable interest expense by the average amount borrowed) for the Middle South System were as follows:

	Year Ended December 31,		
	1986	1985	1984
	(Dollars in thousands)		
Average Borrowing:			
Bank loans	$ 96,270	$118,095	$131,275
Commercial paper	$121,603	$131,978	$116,558
Other	$ 32,542	$ 51,702	$ 50,592
Maximum Borrowing:			
Bank loans	$125,160	$199,695	$219,362
Commercial paper	$125,000	$135,000	$135,000
Other	$ 49,135	$ 54,600	$ 68,625
Year-end Borrowing:			
Bank loans	—	$124,160	$ 10,000
Commercial paper	$105,000	$125,000	$135,000
Other	$ 31,000	$ 49,135	$ 68,625
Average Interest Rate:			
During period—			
Bank loans	8.9%	9.7%	11.9%
Commercial paper	8.1%	9.4%	11.8%
Other	9.2%	9.6%	11.6%
At end of period—			
Bank loans	—	10.1%	9.6%
Commercial paper	7.4%	9.5%	9.6%
Other	8.6%	10.7%	9.0%

Credit facilities at December 31, 1986, 1985, and 1984 and borrowings thereunder of the System companies were as follows:

	December 31, 1986		December 31, 1985		December 31, 1984	
	Credit Facilities	Borrowings	Credit Facilities	Borrowings	Credit Facilities	Borrowings
			(In thousands)			
Short-term:						
Company	—	—	$ 71,500	$ 25,000	$ 71,500	—
SERI	—	—	—	—	$ 24,680	$ 10,000
SFI	$170,000	$131,000	$ 195,000	$ 174,135	$ 210,000	$ 203,625
Operating subsidiaries	$270,485	$ 5,000	$ 158,160	$ 99,160	$ 322,360	—
Long-term:						
Company	$ 60,000	—	—	—	—	—
SERI	$709,450	$709,450	$1,807,167	$1,807,167	$2,089,000	$2,074,000
SFI	$ 50,000	$ 18,000	$ 65,000	$ 42,800	$ 15,000	—

Note 5. Preferred Stock

The number of shares of preferred stock of the operating subsidiaries as of the end of the last two fiscal years was as follows:

	Shares Authorized at December 31, 1986	Shares Outstanding at December 31, 1986	1985	Call Price Per Share
Cumulative, $100 Par Value				
Without sinking fund:				
4.16% — 5.56%	1,070,774	1,070,106	1,070,106	$102.50 to $107.00
6.08% — 8.56%	1,180,000	1,180,000	1,180,000	$102.83 to $105.28
9.16% — 11.48%	795,000	795,000	795,000	$104.06 to $111.11
	3,045,774	3,045,106	3,045,106	
With sinking fund:				
8.52% — 9.00%	850,000	850,000	—	$108.52 to $109.00
10.60% — 12.00%	469,892	469,892	507,464	$106.74 to $112.00
14.75% — 17.00%	284,995	284,995	585,095	$111.58 to $116.16
	1,604,887	1,604,887	1,092,559	
Unissued	5,656,500			
Total	10,307,161			
Cumulative, $25 Par Value				
Without sinking fund:				
8.84%	400,000	400,000	400,000	$27.11
10.40%	600,000	600,000	600,000	$27.95
	1,000,000	1,000,000	1,000,000	
With sinking fund:				
9.92% — 12.64%	6,397,371	6,397,371	6,535,121	$27.01 to $28.16
13.12% — 15.20%	6,227,626	6,227,626	6,377,626	$27.46 to $29.05
19.20%	2,000,000	2,000,000	2,000,000	$28.73
	14,624,997	14,624,997	14,912,747	
Unissued	15,200,000			
Total	30,824,997			

Changes in the number of shares of preferred stock of the operating subsidiaries, all of which were with sinking fund, during the last three fiscal years were as follows:

	Number of Shares		
	1986	1985	1984
Sales:			
AP&L			
8.52%, $100 par	500,000	—	—
LP&L			
19.20%, $25 par	—	—	2,000,000
MP&L			
9.00%, $100 par	350,000	—	—
16.16%, $100 par	—	—	150,000
Redemptions:			
AP&L			
9.92%, $25 par	(18,000)	(58,100)	(79,678)
10.60%, $100 par	—	(6,105)	(13,970)
11.04%, $100 par	(37,572)	(9,245)	(18,045)
13.28%, $25 par	—	(14,000)	(180,434)
LP&L			
10.72%, $25 par	(119,750)	(120,400)	(120,000)
13.12%, $25 par	(85,000)	(80,000)	(80,000)
15.20%, $25 par	(65,000)	(60,000)	—
MP&L			
14.75%, $100 par	(100,000)	—	—
17.00%, $100 par	(200,000)	—	—
NOPSI			
15.44%, $100 par	(100)	—	(14,905)
Total	224,578	(347,850)	1,642,968

The amounts of preferred stock of the operating subsidiaries as of the end of the last two fiscal years were as follows:

	December 31,	
	1986	1985
	(In thousands)	
Without sinking fund:		
Stated at $100 a share	$304,511	$304,511
Stated at $25 a share	25,000	25,000
Premium	1,456	1,456
Total without sinking fund	$330,967	$330,967
With sinking fund:		
Stated at $100 a share	$160,488	$109,255
Stated at $25 a share	365,625	372,819
Premium	728	737
Issuance and discount expense	(18,676)	(15,518)
Total with sinking fund	$508,165	$467,293

Cash sinking fund requirements for the ensuing five years for preferred stock outstanding at December 31, 1986, are as follows (in thousands): 1987, $14,850; 1988, $21,500; 1989, $22,250; 1990, $32,250; and 1991, $41,750. These amounts reflect earlier redemptions of shares of preferred stock which may be applied against future cash sinking fund requirements.

At December 31, 1985, LP&L and NOPSI had an aggregate amount of cumulative preferred stock dividends in arrears of $26.7 million and $.8 million, respectively. In addition, NOPSI had been precluded from making in full its March 1, 1986, preferred stock sinking fund payment. During 1986 all arrearages with respect to the preferred stock dividends of LP&L and NOPSI and the preferred stock sinking fund payment of NOPSI were paid and eliminated.

Subsequent to December 31, 1986, MP&L sold 350,000 shares of its 9.76% Preferred Stock, cumulative, $100 par value.

Note 6.
Long-Term Debt

The long-term debt of the Company and its subsidiaries as of the end of the last two fiscal years was as follows:

	December 31, 1986	December 31, 1985
	(In thousands)	
First Mortgage Bonds	$4,541,658	$3,617,288
Bank Notes:		
Due:		
1987, at federal funds rate plus ⅞ of 1%	—	15,000
1988, at negotiated money market rate	18,000	27,800
1989, at 110% of the sum of prime and 1.3%	473,200	1,476,417
1989, at 11.16% plus 2% (Note 4)	131,250	183,750
1989, at 11.5% plus 2% (Note 4)	105,000	147,000
Total Bank Notes	727,450	1,849,967
Other:		
Long-Term Obligation—Department of Energy (Note 8)	66,729	62,681
Municipal Revenue Bonds—due serially through 2004, 1¼%-8%	29,118	31,793
Pollution Control Revenue Bonds and Installment Purchase Contracts:		
Due serially through 2014, 4.7%-11½%	61,805	62,630
Due 1987—2016, 6⅛%-12½%	896,225	806,226
Less—Funds on deposit with trustees*	—	(106,904)
Purchase Obligations Under Inventory Supply Agreement	28,058	—
Total Other	1,081,935	856,426
Unamortized Premium and Discount—Net	(49,160)	(33,711)
Total Long-Term Debt	6,301,883	6,289,970
Less—Amount Due Within One Year	318,854	609,380
Long-Term Debt Excluding Amount Due Within One Year	$5,983,029	$5,680,590

**Includes $105 million of proceeds from the sale of Pollution Control Revenue Bonds for LP&L held in 1985 by the issuer of the letter of credit pending the participation by other banks in the letter of credit which occurred in December 1986.*

Maturities and sinking fund requirements for the ensuing five years on long-term debt outstanding at December 31, 1986, are as follows:

	Maturities	Sinking Fund Requirements Cash	Sinking Fund Requirements Other**
		(In thousands)	
1987	$317,489*	$ 1,365	$20,341
1988	$352,307*	$ 1,320	$22,920
1989	$221,342*	$54,820	$22,920
1990	$ 54,777	$54,890	$22,638
1991	$410,822	$69,790	$21,368

**Excludes requirements of $215.4 million for escrow payments by SERI for the benefit of the U.S. Banks.*
***Sinking fund requirements may be met by certification of property additions at the rate of 167% of the required amount.*

The outstanding first mortgage bonds of the Company's subsidiaries as of December 31, 1986 and 1985, were:

Maturity	4⅛%—5⅞%	6%—8⅞%	9%—11⅞%	12%—14⅞%	15%—17⅜%	Total
			(In thousands)			
1986						
1987	$ 26,000	—	—	—	—	$ 26,000
1988	$ 15,328	—	$ 45,000	—	—	60,328
1989	—	—	$ 45,000	—	—	45,000
1990	$ 20,800	—	—	—	$ 30,000	50,800
1991	$ 27,000	—	$300,000	—	$ 80,000	407,000
1992-2001	$259,250	$172,760	$915,520	$205,000	$500,000	2,052,530
2002-2011	—	$375,000	$450,000	—	—	825,000
2012-2016	—	—	$600,000	$440,000	$ 35,000	1,075,000
Total First Mortgage Bonds						$4,541,658
1985						
1986	—	—	$ 75,000	—	$ 70,000	$ 145,000
1987	$ 26,000	—	—	—	—	26,000
1988	$ 15,373	—	$ 45,000	—	$125,000	185,373
1989	—	—	$277,000	—	—	277,000
1990	$ 20,900	—	—	—	$ 30,000	50,900
1991-2000	$286,250	$151,960	$137,540	$222,265	$755,000	1,553,015
2001-2010	—	$400,000	$450,000	$ 55,000	—	905,000
2011-2014	—	—	—	$440,000	$ 35,000	475,000
Total First Mortgage Bonds						$3,617,288

Subsequent to December 31, 1986, AP&L redeemed its $80 million, 16½% Series First Mortgage Bonds due February 1, 1991.

Note 7. Retained Earnings

The Holding Company Act of 1935 prohibits the Company's subsidiaries from making loans or advances to MSU. The indenture and charter provisions relating to the operating subsidiaries' long-term debt and preferred stock, respectively, and the provisions of certain of SERI's financing agreements and indenture restrict the amount of consolidated retained earnings available for cash dividends on common stock of the subsidiaries. In addition, transfers by the operating subsidiaries from retained earnings to the stated value of common stock impose similar restrictions on the amount of consolidated retained earnings available for cash dividends on common stock of the subsidiaries. At December 31, 1986, the restricted retained earnings of the Company's consolidated subsidiaries aggregated $1,379.3 million. Accordingly, as of December 31, 1986, $386.4 million of consolidated retained earnings were free from such restrictions, including $375.9 million of unrestricted, undistributed retained earnings of the Company's subsidiaries. However, the $375.9 million of undistributed subsidiary retained earnings does not reflect the ultimate reduction in LP&L's retained earnings which will be occasioned by the LPSC's November 1985 interim rate order permanently disallowing a portion of LP&L's investment in Waterford 3. Further, the unrestricted, undistributed retained earnings of any subsidiary of MSU are not available for distribution to the common stockholders of MSU until such earnings are made available to the Company through the declaration of dividends by such subsidiary. (See Management's Financial Discussion and Analysis and Note 8—"Commitments and Contingencies—Dividend Suspension" and "New Accounting Standard" for further information.)

Prior to January 1987, all of SERI's retained earnings were restricted as to the payment of cash dividends on common stock due to provisions of certain of SERI's financing agreements and its first mortgage bond indentures. The provisions of SERI's Bank Loan Agreements allow SERI the right to pay cash dividends on common stock upon SERI making sufficient prepayments to the U.S. Banks to reduce the amount owing under the U.S. Bank Loan Agreement at maturity to $125 million or less. On January 5, 1987, SERI made a payment under the U.S. Bank Loan Agreement in the amount of $65 million, which was sufficient to reduce the obligations outstanding thereunder to an amount which, among other things, cancelled the suspension pursuant to the Bank Loan Agreements of SERI's right to pay common stock dividends. Consequently, SERI would be permitted to pay common dividends to its parent, MSU, within the limits prescribed in the Foreign Bank Loan Agreement and the Reimbursement Agreements for its Series A and B Pollution Control Revenue Bonds, as described below. The declaration and payment of dividends by SERI is dependent upon appropriate action by SERI's Board of Directors.

As mentioned above, SERI continues to be limited in the payment of cash dividends on common stock by provisions of the Foreign Bank Loan Agreement and the Reimbursement Agreements for its Series A and B Pollution Control Revenue Bonds. Under these agreements, SERI is presently limited in the amount of dividends it may pay on its capital stock (other than dividends payable solely in shares of common stock and dividends payable in cash where, concurrently, SERI receives a capital contribution or sells shares of its common stock) in an amount equal to its accumulated net income for the period July 1, 1985, to the date of the payment. Such amount was approximately $299.6 million as of December 31, 1986. SERI has paid no dividends on its capital stock to date. In the event SERI experienced a loss that exceeded such accumulated net income, less the sum of certain dividends paid since July 1, 1985, dividends could not be paid until such a deficit was restored by subsequently earned net income, except where concurrently SERI receives a capital contribution or sells shares of its common stock.

Note 8. Commitments and Contingencies

Overview

At December 31, 1986, the Middle South System's most significant commitments and contingencies related to (1) challenges to and/or potential reversals of certain of the System operating companies' retail rate orders (see below), (2) ongoing prudence investigations being conducted by various regulatory authorities, (3) appeals of various aspects of the FERC's June 13 Decision relating to the Unit Power Sales Agreement and the System Agreement (see Note 2—"Rate and Regulatory Matters"), (4) the continuing needs of MP&L and NOPSI to access the capital markets for external financing, and (5) the ultimate resolution of the status of Grand Gulf 2 (see "Grand Gulf 2" below).

As mentioned in (1) above, certain of the System operating companies' authorizations are being challenged and the existing rate structures could change, depending upon further actions of regulatory bodies or the courts. In this connection, on February 25, 1987, the Mississippi Supreme Court reversed and remanded the September 1985 order of the MPSC granting permanent rate relief to MP&L with respect to its recovery of Grand Gulf 1 costs. The Supreme Court found reversible error in the MPSC's prior rate order based, in part, on the assertion that the MPSC failed to consider prudence issues. Moreover, separate prudence investigations are also being conducted by the MPSC and the Council relative to MP&L's and NOPSI's respective Grand Gulf 1 cost recoveries. In addition, the prudence issue involving LP&L's expenditures on Waterford 3 remains unresolved. For further information regarding these rate issues and/or the financial implications that could result if MP&L or NOPSI were rendered unable to meet their respective Grand Gulf 1 obligations to SERI, see Note 2—"Rate and Regulatory Matters," Note 7—"Retained Earnings," and "Potential Debt Acceleration and Related Matters" discussed below.

Capital Requirements and Financing

Construction Requirements. The Middle South System's construction program contemplates the following estimated expenditures (including AFUDC):

	1987	1988	1989
		(In Millions)	
Construction expenditures	$465.0	$418.2	$457.9
AFUDC (included above)	$ 19.9	$ 17.0	$ 14.6

Construction expenditures include significant amounts for transmission facilities, distribution facilities, and miscellaneous utility plant. Costs for post-commercial operation work on Grand Gulf 1 and Waterford 3 are also included. No significant costs in connection with new generating facilities are expected to be incurred. The above construction expenditures assume virtually no construction activities at Grand Gulf 2 except for demobilization and suspension. Effective September 18, 1985, SERI suspended construction activities on Grand Gulf 2 following an order of the MPSC. (See "Grand Gulf 2" below for information regarding the future status of this unit.) Through December 31, 1986, SERI had invested $4,266 million (excluding nuclear fuel) in connection with its 90% ownership interest in the Grand Gulf Station. SERI estimates, pending a final review of the cost allocation between the two units, that of this total, $3,358 million was invested by SERI in Grand Gulf 1 and $908 million in Grand Gulf 2.

Rate Deferrals and Associated Capital Requirements. At December 31, 1986, all of the System operating companies had received authorization from their respective state or local regulatory authorities for cost recoveries from ratepayers which they believed would be sufficient to meet their respective purchased power expenses for Grand Gulf 1. These purchased power expenses arise under the Unit Power Sales Agreement which, as approved in the FERC's June 13 Decision, obligates the System operating companies to purchase all of SERI's share of the capacity and energy from Grand Gulf 1. (See Note 2—"Rate and Regulatory Matters.")

In accordance with the rate moderation plans implemented for AP&L, MP&L, and NOPSI and an assumed rate moderation plan to be implemented for LP&L's service territory in the 15th Ward of the City of New Orleans, these companies would require additional capital of approximately $1,030.8 million through 1989 in connection with Grand Gulf 1-related costs for AP&L, MP&L, and NOPSI and Waterford 3 costs for LP&L. See Note 2—"Rate and Regulatory Matters" for information with respect to such rate moderation plans including continuing regulatory proceedings and litigation with respect thereto. In addition, see Note 1—"Summary of Significant Accounting Policies—Rate Deferrals" for a discussion of the accounting policies related to rate deferrals.

The System operating companies estimate that approximately $208.2 million will be externally financed in the period of 1987-1989 in connection with the above-mentioned rate moderation plans and contemplated construction expenditures. This estimate excludes external financing requirements for the refunding of maturing long-term debt and sinking fund requirements on preferred stock, the refinancing of nuclear fuel leases and the repayment of short-term debt. In the event that any of the existing rate phase-in plans were abrogated or rescinded, or the future recovery by any System operating company under its phase-in plan of deferred costs were disallowed in any material respect, the earnings, liquidity, and financial condition of the particular System operating company, and its ability to effect external financing to meet its continuing obligations (including those with respect to Grand Gulf 1) could be severely impaired.

Capital Requirements with Respect to Refinancing. The Middle South System will require approximately $1,079.7 million through 1989 to refinance maturing long-term debt and to meet cash sinking fund requirements with respect to first mortgage bonds and preferred stock. Of this amount, $763.0 million represents SERI's payment obligations under its various borrowing arrangements. Maturing long-term debt and preferred stock sinking fund requirements are expected to be refinanced through a combination of internally and externally generated funds. Also, unless extended, the expiration of certain fuel inventory financing arrangements of SFI and nuclear fuel leasing arrangements of the System operating companies and SERI during 1987-1989 could result in additional capital requirements.

The capital requirements of the System operating companies noted above may vary in the event of modification of (1) the rate structures implemented by the System operating companies as a result of prudence investigations or otherwise, (2) the FERC's allocation of Grand Gulf 1 capacity and energy in the June 13 Decision, or (3) its allocation of other energy costs under the System Agreement in the June 13 Decision. The June 13 Decision is the subject of judicial review and the ultimate outcome cannot be predicted. (See Note 2—"Rate and Regulatory Matters.")

Potential Debt Acceleration and Related Matters

As noted above, the Mississippi Supreme Court has reversed and remanded the prior MPSC rate order granting MP&L permanent rate relief with respect to its recovery of Grand Gulf 1 costs, and MP&L's rate structure established by that rate order is under further review by the MPSC. Further, the Council is continuing to conduct a prudence inquiry into NOPSI's involvement in Grand Gulf 1. In this connection, the Council's consultants have recommended, notwithstanding the March 1986 rate settlement between NOPSI and the Council, that NOPSI could economically sustain substantial additional disallowances with respect to its allocable share of Grand Gulf 1 costs. The Company cannot predict the outcome of these matters or whether the current rate structures of these two operating companies will remain in effect. Without adequate rates to recover Grand Gulf 1 charges, MP&L and NOPSI could suffer such liquidity constraints that they would, in a short period of time, be unable to meet their contractual obligations to SERI in respect to the Grand Gulf Station.

Unless (1) waivers were obtained, (2) the debt was restructured or (3) other arrangements could be negotiated, the failure of either MP&L or NOPSI to make the required payments to SERI or to maintain their current rate structures might, under certain agreements related to SERI's indebtedness (but only upon further action by the requisite percentage of SERI's creditors), lead to acceleration of such indebtedness. In the absence of such waivers, debt restructuring or other negotiated arrangements, acceleration of such indebtedness could also occur (1) if either operating company were rendered insolvent as a result of a substantial reduction in retail rates, or (2) if an MPSC proceeding relating to the certificate of convenience and necessity for the Grand Gulf Station were to make the continued operation of Grand Gulf 1 impractical. (See Note 2—"Rate and Regulatory Matters" for a discussion of this MPSC proceeding.)

Given the substantial amount of SERI's debt, it would not be able to meet its obligations, if accelerated. Under SERI's financing agreements, MSU, and not the System operating companies, would be responsible to pay SERI's accelerated obligations if SERI could not. MSU, with its financial resources currently limited, would not at this time be in a position to fully satisfy SERI's obligations, if accelerated.

In addition, the ability of various Middle South System companies to obtain financing in the capital markets could be impaired and, in the event of insolvency of a System operating company, certain of the financing arrangements and leases of the Middle South System's fuel subsidiary, SFI, could require payments by the System operating companies, MSU, or SERI.

Dividend Suspension

In light of the uncertainties continuing to face the Middle South System as well as the need to conserve cash resources in view of these uncertainties, the System operating companies have not declared dividends on their common stock since the second quarter of 1985. SERI likewise did not declare a common dividend because of, among other things, limitations under its bank loan agreements. (See Note 7—"Retained Earnings" for information regarding SERI's satisfaction of requirements for termination of certain restrictions on the payment of common stock dividends.) MSU has been unable to declare its own common stock dividend since that time. MSU's ability to declare dividends in excess of dividends received from its subsidiaries is limited by the amount of MSU's unrestricted corporate retained earnings available for that purpose. Resumption of MSU's common stock dividends may depend, among other things, upon the further resolution or moderation of the uncertainties and continued improvement in the financial condition of the Middle South System.

Capital Funds, Availability and Reallocation Agreements

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

The System operating companies are severally obligated under the Availability Agreement in accordance with stated percentages (AP&L 17.1%, LP&L 26.9%, MP&L 31.3%, NOPSI 24.7%) to make payments or subordinated advances adequate to cover all of the operating expenses, including depreciation, of SERI. In November 1981 the System operating companies entered into a Reallocation Agreement which would have allocated the capacity and energy available to SERI from the Grand Gulf Station and the related costs to LP&L, MP&L, and NOPSI. These companies thus agreed to assume all the responsibilities and obligations of AP&L with respect to the Grand Gulf Station under the Availability Agreement and Power Purchase Advance Payment Agreement with AP&L relinquishing its rights to capacity and energy from the Grand Gulf Station. Each of the System operating companies, including AP&L, however, would have remained primarily liable to SERI and its assignees for payments or advances under these agreements. AP&L was obligated to make its share of the payments or advances only if the other System operating companies were unable to meet their contractual obligations. However, the FERC's June 13 Decision allocating a portion of Grand Gulf 1 capacity and energy to AP&L supercedes the Reallocation Agreement insofar as it relates to Grand Gulf 1. (See Note 2—"Rate and Regulatory Matters" for further information.)

Grand Gulf 2

As of December 31, 1986, SERI had invested approximately $908 million in Grand Gulf 2 (including approximately $390 million of AFUDC) which was approximately 34% complete based on the estimated man-hours needed to complete the unit. From late 1979 until September 1985, only a limited amount of construction was performed on Grand Gulf 2. SERI had been accruing and capitalizing AFUDC on its investment in Grand Gulf 2 at the rate of approximately $8 million per month. Effective September 18, 1985, SERI suspended construction activities and ceased accruing AFUDC on Grand Gulf 2 following an order of the MPSC.

Since September 1985 SERI has continued suspension of construction on Grand Gulf 2 and has limited expenditures to only those activities which are absolutely necessary for demobilization and suspension of the unit. In November 1986 a special group (Study Team) formed by management, which included Middle South System officials and outside consultants, completed a comprehensive year-long study that analyzed in-depth the various alternatives regarding Grand Gulf 2 and the complex issues concerning its future status. After considering the various alternatives, SERI's Board of Directors (with the MSU Board of Directors concurring), in December 1986, adopted the recommendation of the Study Team that suspension of construction be continued and that a further decision be made by 1990 on the future status of Grand Gulf 2, in light of alternatives available at that time.

During the period of continuation of suspension, SERI's expenditures on Grand Gulf 2 will be limited, and it will continue not to accrue and capitalize AFUDC on its investment in the unit. Consequently, during the suspension period, the increase in SERI's investment in Grand Gulf 2 will be limited and SERI will forego any return on this investment. Further, SERI does not intend to make an application to the FERC during the period of suspension with respect to recovery through rates of its investment in Grand Gulf 2. SERI will continue during the suspension period to evaluate various alternatives for the future of Grand Gulf 2 and will also continue to assess whether certain equipment or facilities should continue to be carried at their full cost. Any determination that the value of SERI's investment should be reduced and the amount of any such reduction written off could adversely affect various companies in the Middle South System. Certain issues relating to the value of SERI's investment in Grand

Gulf 2 also exist in connection with an audit by the FERC discussed below in "FERC Audit of SERI."

Under the Foreign Bank Loan Agreement, SERI has covenanted to limit capital expenditures (other than those required by regulation) to not in excess of $80 million per annum in the aggregate. Unless waived, this covenant would preclude resumption of full construction of Grand Gulf 2 prior to 1989. (See Note 4—"Lines of Credit and Related Borrowings" for further information.)

While SERI believes that all of its investment to date in Grand Gulf 2 has been prudent, in connection with any subsequent decision as to the value of Grand Gulf 2 or the ultimate decision with respect to the future of Grand Gulf 2, SERI will, at an appropriate time, make a determination as to the appropriate recovery of its investment. In making such determination, SERI would consider, among other things, the regulatory environment, generally, and legal standards then applicable. Any action to seek recovery of Grand Gulf 2 costs would likely involve a filing by SERI with the FERC requesting such recovery, over a period of years, through charges to the System operating companies, and related filings by the System operating companies before state or local regulatory authorities to recognize the FERC-allowed charges in retail rates. There can be no assurance that SERI would be permitted by the FERC to recover the full amount of its investment in Grand Gulf 2. Proceedings before the FERC and, with respect to recognition in retail rates of FERC approved rates, before state or local regulatory authorities, could be protracted and strongly contested on various grounds, including imprudence. If costs associated with Grand Gulf 2 were allocated to the System operating companies and they were unable to recover these costs from their customers, the System operating companies' financial condition could be materially and adversely affected. Any non-recovery of SERI's investment in Grand Gulf 2 would result in a charge against earnings or restatement of prior years' financial statements for any unrecoverable investment when that event becomes probable. In the event such a charge were substantial, the financial condition of SERI could be materially and adversely affected (although its cash position would not be adversely affected), and SERI's ability to pay dividends on its capital stock could be impaired. Reference is made to "New Accounting Standard" below for information concerning an accounting standard which addresses the accounting treatment of the issues discussed herein.

In view of the controversies over the Grand Gulf Station, including the adverse reaction of various rate regulatory bodies to allocation of costs, and regulatory uncertainties, including ratemaking, attendant to a delay in the decision as to the future of Grand Gulf 2, there can be no assurance that the full cost of Grand Gulf 2 will be recovered or as to the timing of any recovery. In addition, during the period to 1990, certain issues, as described above, could cause a decrease in the valuation of the investment in Grand Gulf 2. Failure to obtain rate relief for all or a substantial portion of the cost of Grand Gulf 2 could have a material and adverse effect upon the financial condition of SERI, MSU, and possibly the Middle South System operating companies, depending upon, among other things, the timing of the realization of any such loss.

FERC Audit of SERI

The FERC has performed an audit of SERI and the Grand Gulf Station as part of its regulatory function in auditing utilities subject to its jurisdiction, and, on May 8, 1986, the FERC Staff sent to SERI for review and comment a draft audit report outlining the Staff's tentative findings and recommendations. The draft report included preliminary findings which (1) questioned SERI's accrual of AFUDC on Grand Gulf 2 as a construction cost during the period of 1979-1985 during which time construction work on the unit was limited and (2) questioned SERI's accounting for its unrealized tax benefits in relation to the computation of AFUDC on the Grand Gulf Station. On June 13, 1986, SERI submitted a response to the FERC Staff's draft report disagreeing with most of the Staff's preliminary findings. The FERC Staff held a meeting with SERI on September 10, 1986, to discuss the issues raised in the draft report and has indicated that it would require additional information and time to consider certain issues. If the FERC Staff's preliminary findings are adopted and sustained, the resolution of certain of these issues could have a significant adverse impact on SERI. SERI cannot predict the ultimate outcome of this examination.

New Accounting Standard

The accounting standards related specifically to public utilities and certain other regulated enterprises are set forth in SFAS Nos. 71 and 90. SFAS No. 90, Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs, was issued by the FASB in December 1986 as an amendment of SFAS No. 71. It provides that, when an abandonment of a plant or a disallowance of costs with respect to a newly completed plant becomes probable, the following amounts, net of related tax benefits, would be reported either by restating the appropriate prior years' financial statements or by charging it against current income: (1) the cost of an abandoned plant in excess of the present value of estimated recoveries, or (2) the amount of a partial disallowance by regulators of a recently completed plant for ratemaking purposes. The new statement is effective for fiscal years beginning after December 15, 1987, with retroactive application for prior transactions. SFAS No. 90 will not have any current effect upon SERI in light of the decision to continue suspension of Grand Gulf 2 (see above). The provisions of SFAS No. 90 would apply should SERI decide to abandon Grand Gulf 2. However, SFAS No. 90 will have an impact on LP&L's retained earnings due to the revisions made in the accounting treatment of cost disallowances of newly completed plants related to (2) above. Specifically, LP&L's November 1985 retail rate order includes the disallowance of $284 million (less related tax benefits) of LP&L's investment in Waterford 3 which, under the new standard, is to be recognized as a loss in the manner stated above. LP&L presently plans to record this adjustment in early 1988 which will reduce its retained earnings. However, because of the related complex income tax implications, LP&L has not finally determined whether the adjustment will be reported by restating the appropriate prior years' financial statements or by charging it against current income in 1988.

The FASB had previously indicated that the new standard would also include revisions in accounting for the phase-in of rates associated with the costs of new generating plants. However, SFAS No. 90 did not address this topic. The existing rate structures of AP&L, MP&L, and NOPSI include phase-in plans for recovery of costs related to Grand Gulf 1 which meet the current requirements of SFAS No. 71. (As noted above, however, the Mississippi Supreme Court in February 1987 reversed and remanded MP&L's rate phase-in plan to the MPSC for further consideration.) In light of the many complex issues raised as to the accounting for rate phase-in plans, the FASB has resumed deliberations to consider this subject further. It cannot be predicted what action, if any, the FASB will ultimately take regarding this matter.

Shareholder Litigation

In 1985, MSU, certain other Middle South System companies, and individuals became defendants in a purported class action suit. The initial complaint was filed in August 1985 by an MSU shareholder (purporting to represent a class that purchased MSU common stock) followed by four similar complaints filed by MSU shareholders in August and September 1985. The five actions were consolidated in the U.S. District Court for the Eastern District of Louisiana. The consolidated, amended, and supplemental complaint alleged violations of the disclosure requirements of the Securities Exchange Act of 1934 and the Securities Act of 1933, common law fraud and common law negligent misrepresentation in connection with the financial condition of MSU and prayed for compensatory and punitive damages, legal costs and fees and other proper relief against MSU, various other System companies and certain officers (and former officers) and directors of MSU, the Company's outside auditors and certain underwriters of MSU common stock. In April 1986, MSU and the other defendants filed a motion to dismiss or, in the alternative, a motion for summary judgment. On January 12, 1987, the District Court entered a judgment granting defendants' motions for summary judgment and dismissed the suit. On February 6, 1987, the plaintiffs in the consolidated action filed a Notice of Appeal in the U.S. Court of Appeals for the Fifth Circuit. The defendants intend to vigorously oppose the appeal of the District Court's decision. In the event the dismissal is reversed on appeal, the eventual outcome and impact on the Middle South System's financial condition cannot be predicted.

Fuel Contracts

SFI has a number of contracts for the purchase of fuels for use at various generating stations within the Middle South System. Among the contracts is one for an estimated 100 million tons of coal for LP&L's proposed Wilton Station (discussed below), another expected to provide for at least thirty years of the projected coal requirements of the Independence Station in Arkansas and another for 33 million tons of lignite for AP&L's share of a future power station in Arkansas (also discussed below). In addition, SFI has a long-term oil supply agreement with a major oil company providing for the purchase of 25,000 barrels of oil per day through 1996 with an option to reduce, within certain limits, the contract quantity either temporarily or permanently. An agreement was reached, effective June 1, 1985, temporarily reducing SFI's obligation to purchase fuel oil to 200,000 barrels per month through November 1987. AP&L is currently purchasing coal for the White Bluff Station under an agreement that will provide approximately 100 million tons of coal over a 20-year period.

LP&L, by separate agreement, guaranteed SFI's performance under the coal contract for the Wilton Station and agreed to purchase the coal from SFI. SFI, after having kept the coal supplier advised of possible delays, advised the supplier, in August 1985, that, based on its latest appraisal, for planning purposes, the System's requirement for additional coal capacity is now forecast to be in a time frame which makes the existing contract in fact non-viable. The supplier has refused to agree that regulatory constraints or any other difficulties have constituted events of force majeure under the coal supply agreement. Upon receipt of the August 1985 notification the supplier filed a Demand For Arbitration under the coal supply agreement to establish that the agreement remains in full force and effect and that SFI is not excused from performing its obligations and, alternatively, that SFI's actions constitute anticipatory repudiation of the coal supply agreement. The parties have agreed to a postponement of the arbitration on the basis that it can be restarted by either party on 10-days notice. LP&L has filed an application with the LPSC for a certificate authorizing the construction of the Wilton plant within a time frame of 1995 or earlier. In view of the reduction in projected load requirements within LP&L's service area since the time the coal supply agreement was entered into and in view of other factors relating to LP&L, there is a strong likelihood that the LPSC will not grant such a certificate. It is the opinion of SFI's counsel that a refusal by the LPSC to grant a certificate on a reasonable basis will constitute the existence of a force majeure which would relieve LP&L and SFI of a substantial part, if not all, of their obligation under the coal supply agreement. SFI, LP&L, and the coal supplier have entered into discussions concerning, among other things, a possible new arrangement. Resolution of this matter could possibly expose SFI and LP&L to claims for significant damages in the event SFI does not ultimately prevail in asserting that events of force majeure have excused performance or in the event efforts to mitigate any possible damages are unsuccessful.

SFI executed a contract, as amended in November 1982, for the purchase of lignite to be used at a future lignite-fueled power plant in Arkansas. Arkansas Electric Cooperative Corporation (AECC) has agreed to become an owner of 50% of the proposed plant and assume 50% of SFI's obligation to purchase lignite. Delivery of lignite is tied to the commercial operation of the plant, which may be delayed at the owner's option until June 1995. AP&L has guaranteed SFI's performance and agreed to purchase SFI's share of the lignite, which assuming half ownership of the plant is approximately 33 million tons, over a 30-year period. The contract, including the guaranty, is conditional upon the receipt of regulatory approvals for the construction of the plant. Based on the System's latest appraisal, for planning purposes, the requirements for additional coal capacity is now forecast to be in a time frame which makes this contract non-viable. AP&L, AECC, and the coal supplier have entered into discussions with respect to terms of a new or restructured agreement.

Nuclear Liability Insurance

As of December 31, 1986, the Price-Anderson Act (Act) limited the public liability of a licensee of a nuclear power plant to $695 million for a single nuclear incident. This limit will increase by $5 million for each additional operating license issued by the Nuclear Regulatory Commission (NRC). Insurance for this exposure is provided by private insurance and an indemnity agreement with the NRC. Every licensee of a nuclear power plant is obligated, in the event of a nuclear incident involving any commercial nuclear facility in the United States that results in damages in excess of the private insurance, to pay retrospective assessments of up to $5 million per incident for each licensed reactor it operates or up to a maximum per reactor owned of $10 million in any calendar year. The Middle South System has four licensed reactors. This Act is scheduled to expire in August 1987, and the U.S. Congress is considering several proposals to amend it. The Middle South System is unable to predict what action Congress might ultimately take regarding the Act and what effect such action might have on the System's potential liability.

The System operating companies are each member-insureds of Nuclear Electric Insurance Limited (NEIL), a mutual insurer that provides its members with insurance coverage for certain costs of replacement power incurred due to certain prolonged outages of nuclear units (NEIL I). In addition, AP&L, LP&L, and SERI are member-insureds under NEIL II, an excess property insurance program, which provided $610 million (as of January 15, 1987) of coverage for property damage sustained by the insured in excess of $500 million caused by radioactive contamination or other specified damage. AP&L has an additional $120 million of excess property and decontamination insurance with American Nuclear Insurers (ANI), a pool of private insurance carriers, thus giving AP&L a total of $730 million excess property and decontamination insurance above the $500 million primary amount. LP&L and SERI are member-insureds under a primary property damage insurance program provided by Nuclear Mutual Limited, another mutual insurer. AP&L's primary property and decontamination damage insurance is provided by ANI. As member-insureds with these mutuals, the System operating companies and SERI are subject to assessments if losses exceed the accumulated funds available to the insurer. The present proposed maximum assessment for incidents occurring during a policy year is approximately $19 million, $35 million, $0.43 million, $0.41 million, and $40 million for AP&L, LP&L, MP&L, NOPSI, and SERI, respectively.

Spent Nuclear Fuel and Decommissioning Costs

Under the terms of their nuclear fuel leases, AP&L, LP&L, and SERI are responsible for the disposal of spent nuclear fuel. These companies consider all costs incurred or to be incurred in the use and disposal of nuclear fuel to be proper components of nuclear fuel expense and provisions to recover such costs have been or will be made in applications to regulatory commissions. The affected Middle South System companies have executed contracts with the Department of Energy (DOE) whereby the DOE will furnish disposal service for the companies' spent nuclear fuel at a cost of one mill per kilowatt-hour of gross generation on or after April 7, 1983, plus (in AP&L's case) one-time fees for previously discharged fuel and in-core burned fuel prior to that date. AP&L has selected an option made available by the DOE to pay the one-time fee, plus interest accrued until date of payment, no earlier than 1998. AP&L has recorded the approximately $66.7 million necessary for payment to the DOE for the disposal of all spent nuclear fuel on hand at April 6, 1983, including accrued interest. In addition to the recovery of costs associated with the disposal of spent nuclear fuel, AP&L is recovering a total of approximately $160 million for decommissioning costs for its two nuclear units. Based upon a study performed by AP&L, nuclear plant decommissioning costs are projected to be in excess of this amount. AP&L will request recovery of estimated increased costs in applications to its regulatory commissions. LP&L and SERI are presently recovering annually a total of approximately $2.1 million and $1.1 million, respectively, for decommissioning costs for their respective nuclear units.

LP&L and NOPSI Consolidation

In the interest of increased economic efficiency, LP&L and NOPSI have developed a long-term plan to consolidate the two companies and their operations. Under the proposed arrangement, subject to the receipt of necessary regulatory and other approvals, the two companies would be consolidated into a new company to be called Louisiana Power & Light Company. MSU, which currently owns all the outstanding common stock of LP&L and NOPSI, would own all the common stock of the new company.

Note 9. Leases

The Company's operating subsidiaries account for leases entered into prior to 1983 on the same basis as that used by their respective regulatory authorities in the ratemaking process that determines the revenues utilized to recover the lease costs. The Company's operating subsidiaries account for capital leases entered into subsequent to 1982 in accordance with SFAS No. 13 and SFAS No. 71.

Beginning in 1987, compliance with SFAS No. 71 for capital leases entered into prior to 1983 will require recording the following assets and liabilities on the balance sheet:

	1986	1985	1984
	(In thousands)		
Assets:			
Utility plant	$142,911	$136,076	$136,245
Accumulated amortization	(40,012)	(32,522)	(29,188)
Net	$102,899	$103,554	$107,057
Other property and investments—net	$ 47,151	$ 48,700	$ 50,264
Liabilities:			
Non-current obligations under capital leases	$141,224	$144,472	$149,060
Current obligations under capital leases	$ 13,702	$ 12,923	$ 13,279

The above amounts exclude nuclear fuel leases which will also be recorded on the balance sheet in 1987. The recording of these capital leases would not affect the amounts reported as either expenses or net income.

At December 31, 1986, the System companies had noncancellable leases (excluding nuclear fuel leases), presently accounted for as operating leases, with minimum rental commitments as follows:

	(In thousands)
1987	$ 78,136
1988	75,717
1989	70,793
1990	59,945
1991	56,185
For years thereafter	411,540
Total	$752,316

Rental expense for capital and operating leases (excluding nuclear fuel leases) amounted to approximately $76.6 million, $70.5 million, and $68.2 million in 1986, 1985, and 1984, respectively.

Three subsidiaries have entered into nuclear fuel leases aggregating $465 million. The leases, unless terminated sooner by one of the parties, will continue through 2018, 2028, and 2029. Credit lines supporting these nuclear fuel leases have not been extended and are currently scheduled to terminate in 1987 unless present credit lines are extended or new lines are secured. It is currently assumed that such credit lines will either be extended pursuant to agreements subsequently negotiated or that alternative new lines will be secured. Lease payments, which are not included in the tabulations above, are based on nuclear fuel use. Nuclear fuel lease expense of $161.4 million, $111.8 million, and $72.7 million was charged to operations in 1986, 1985, and 1984, respectively. The unrecovered cost base of the leases was $410.8 million, $400.1 million, and $433.1 million at December 31, 1986, 1985, and 1984, respectively.

Note 10. Postretirement Benefits

The companies of the Middle South System have various postretirement benefit plans covering substantially all of their employees.

Pension plans are administered by a trustee who is responsible for pension payments to retirees. Various investment managers have responsibility for management of the plans' assets. In addition, an independent actuary performs the necessary actuarial valuation for the individual company plans.

Total pension cost of the Company and its subsidiaries for 1986, 1985, and 1984 was $13.4 million, $17.1 million, and $28.4 million, respectively. The decrease in 1985 pension cost compared with 1984 results primarily from changes in actuarial assumptions and in actuarial cost methods by certain of the System companies. The principal elements included in the assumption changes were an increase in the assumed rate of return used in determining the actuarial present value of projected plan benefits from 7% or 8% to 9% and an equivalent increase at each age in expected salary increases for active plan participants. In addition, certain of the System companies changed the actuarial cost method and the amortization method for recognizing the difference between assets and past service liabilities. These changes had the net effect of reducing 1985 pension cost by $20.1 million. These decreases were partially offset by increases in pension cost of approximately $7.9 million due to amendments effective January 1, 1985, to comply with the Retirement Equity Act and a special early retirement program, which was offered for a limited period in 1985 to certain employees of certain System companies.

The comparison of the actuarial present values of accumulated pension plan benefits and plan net assets for the defined benefit plans is presented below. This comparison was determined in accordance with the provisions of SFAS No. 36 which require the use of certain assumptions that are different from those used by the System companies' actuary in determining an appropriate level of funding for the System companies.

	January 1,	
	1986	1985
	(In thousands)	
Actuarial present value of accumulated pension plan benefits:		
Vested	$305,000	$261,781
Nonvested	17,465	15,481
Total	$322,465	$277,262
Net assets available for pension benefits	$534,207	$446,757

The assumed rate of return used in determining the actuarial present value of accumulated pension plan benefits was 9%.

As part of the sale of the transit operation on June 30, 1983, NOPSI agreed to transfer the pension plan assets and liabilities of the transit related participants to a separate plan to be maintained by the successor employer. The 1986 and 1985 present value of accumulated benefits and the value of assets do not include amounts attributable to former transit related participants. While such transfer was effective as of the date of the sale, the transfer was not completed until October 1986.

During 1985, new standards for employers' accounting for pensions were issued (SFAS No. 87). The System companies will adopt the new pension accounting and disclosure standards in 1987. However, it is not expected that the new standards will have a material adverse impact on the System companies' financial position or results of operations.

The System companies also provide certain health care and life insurance benefits for retired employees. Substantially all employees may become eligible for these benefits if they reach retirement age while still working for the System companies. These benefits and similar benefits for active employees are provided through various means including payments of premiums to insurance companies and/or accruals for self insurance policies managed by insurance companies. The System companies recognize the cost of providing these benefits by expensing the payments made to the insurance companies or accruing the cost as recommended by the managing insurance company. The cost of providing these benefits for retirees is not separable from the cost of providing benefits for active employees. The total cost of providing these benefits and the number of active employees and retirees for the last three fiscal years were as follows:

	1986	1985	1984
Total cost of health care and life insurance (in thousands)	$25,718	$19,771	$20,869
Number of active employees	13,307	13,214	12,955
Number of retirees	2,983	2,577	2,430

Note 11.
Settlement Agreements with Gas Suppliers

A dispute between a gas supplier and LP&L arising from the gas supplier's claimed inability to deliver full quantities of fuel gas due LP&L under several natural gas contracts was settled by the execution of a settlement agreement on June 4, 1982. The settlement agreement provides for the payment of $1.087 billion in cash plus a guaranty of savings of at least $585 million in certain gas acquisition costs between 1982 and 1996. In March 1983, the LPSC ordered in general that the refunds be made as follows: the $587 million received by LP&L on June 4, 1982, plus interest, or a total of $637 million, shall be refunded in 1983; the $250 million received in January 1983 shall be refunded in ten equal annual installments beginning in 1984; and the $250 million received in January 1984 shall be refunded in nine equal annual installments beginning in 1985. In addition, in February 1984 the LPSC ordered LP&L to refund $32.6 million, representing interest not already covered in its March 1983 refund order, to customers in equal annual installments over a nine-year period beginning with the 1985 refund. As a result of the LPSC orders, LP&L accrued in 1985 and 1984 net interest expense in the amounts of $.2 million and $9.2 million, respectively. There was no accrual for 1986. Through December 31, 1986, LP&L had refunded a total of approximately $770 million to its customers. On January 30, 1987, the LPSC issued a rate order which, among other things, ordered LP&L to make no further refunds to its customers of the proceeds of the aforementioned settlement. As of January 30, 1987, the amount subject to refund to these customers was approximately $386 million. However, the amount applicable to LP&L's service territory in the 15th Ward of the City of New Orleans will continue to be refunded. (See Note 2—"Rate and Regulatory Matters".)

A settlement has been negotiated between NOPSI and a gas supplier in long-standing litigation stemming from the gas supplier's failure to deliver obligated quantities of natural gas for power plant use during the period 1973-1975. If approved by the parties to the suit and the courts, the settlement would result in the refund of approximately $70 million to electric customers served by NOPSI in that time frame. Announcement of the settlement was made in February 1987.

Two lawsuits between MP&L and a gas supplier arising from MP&L's claim that the gas supplier breached the terms of a Gas Sales Agreement were settled by the execution of a settlement agreement between the parties on September 25, 1985. The settlement required that the gas supplier pay MP&L $165 million on September 25, 1985, and an additional $17.5 million by September 25, 1987. On August 1, 1986, MP&L made a filing with the MPSC proposing a plan for the distribution of these funds. On October 6, 1986, the MPSC entered an order which established a plan of distribution (Distribution Plan) for the funds to MP&L's customers. Under the

Distribution Plan, the settlement proceeds will be allocated between MP&L's wholesale and retail customers and refunded to MP&L's retail customers in two distributions, with the first distribution, which represents a substantial portion of these funds, to be completed by April 1, 1987, and the second after the $17.5 million payment is received from the gas supplier in September 1987. On January 16, 1987, in accordance with the Distribution Plan discussed above, MP&L refunded approximately $18 million to 12 former wholesale customers.

Note 12. Quarterly Results (Unaudited)

Consolidated operating results for the four quarters of 1986 and 1985 were as follows:

Quarter Ended	Operating Revenues	Operating Income	Net Income (Loss)	Earnings (Loss) Per Share
	(In thousands, except per share amounts)			
1986:				
March	$ 804,809	$296,699	$114,587	$ 0.56
June	$ 810,795	$282,663	$103,393	$ 0.51
September	$1,073,400	$349,943	$171,495	$ 0.84
December	$ 796,908	$232,940*	$ 61,827*	$ 0.30*
1985:				
March	$ 754,147	$147,587	$135,466	$ 0.71
June	$ 749,937	$139,286	$125,147	$ 0.63
September	$ 948,543	$288,108	$149,357	$ 0.73
December	$ 785,832	$141,070**	$ (8,979)**	$(0.04)**

**Includes the net effect of certain write-offs recorded in the quarter ended December 31, 1986, of approximately $19.6 million or $0.10 per share. (See "Management's Financial Discussion and Analysis—Results of Operation.")*

***Includes the net effect of certain provisions for estimated losses recorded in December 1985 of approximately $66.1 million or $0.33 per share. The decrease in the quarter ended December 1985 resulted primarily from (1) the effect of Grand Gulf 1 having entered commercial operation without retail rates in place to recover NOPSI's costs associated with this unit, (2) the absence of an AFUDC accrual on the Grand Gulf Station and Waterford 3 during the fourth quarter of 1985, and (3) the recording of certain provisions for estimated losses as noted above (See "Management's Financial Discussion and Analysis—Results of Operation.")*

The business of the Middle South System is subject to seasonal fluctuations with the peak period occurring during the summer months. Accordingly, earnings information for any three-month period should not be considered as a basis for estimating results of operations for a full year.

Selected Financial Data—Five-Year Comparison
(In thousands, except per share amounts)

	1986	1985	1984	1983	1982
Net operating revenues	**$ 3,485,912**	$ 3,238,459	$ 3,146,035	$ 2,909,657	$ 2,846,264
Net income	**$ 451,302**	$ 400,991	$ 508,437	$ 378,050	$ 310,595
Earnings per share	**$ 2.21**	$ 2.01	$ 2.86	$ 2.46	$ 2.33
Dividends declared per share	—	$ 0.89	$ 1.75	$ 1.71	$ 1.67
Total assets	**$14,358,531**	$13,665,037	$12,565,546	$11,107,166	$10,364,653
Long-term debt (excluding current maturities)	**$ 5,983,029**	$ 5,680,590	$ 5,865,304	$ 5,032,175	$ 4,429,447
Preferred stock with sinking fund	**$ 508,165**	$ 467,293	$ 476,928	$ 429,601	$ 354,957

Composite Common Stock Prices and Dividends by Quarter

1986	First	Second	Third	Fourth
Price Range High-Low	$13¾-10½	$14⅜-12⅛	$15-12	$14⅛-12¼
Dividend Declared	—	—	—	—
1985				
Price Range High-Low	$14⅝-12¾	$15¼-12⅞	$15¼-8⅛	$10⅞-8½
Dividend Declared	$.44½	$.44½	—	—

Five-Year Consolidated Summary of Financial Information

Middle South Utilities, Inc. & Subsidiaries

(Dollars in thousands, except per share amounts)

Consolidated Summary of Operations	1986	1985	1984	1983	1982
Operating Revenues:					
Electric	$ 3,339,132	$ 3,084,877	$ 2,959,570	$ 2,716,329	$ 2,673,572
Natural gas	146,780	153,582	186,465	193,328	172,692
Total	3,485,912	3,238,459	3,146,035	2,909,657	2,846,264
Operating Expenses:					
Operation:					
Fuel for electric generation	884,560	1,001,373	1,020,280	942,219	1,066,325
Purchased power	128,405	230,399	291,129	373,712	345,076
Gas purchased for resale	98,337	120,542	134,420	158,186	138,890
Deferred fuel and other	703,153	593,571	465,713	363,509	288,283
Maintenance	242,261	176,293	161,433	149,453	132,031
Depreciation	346,361	265,500	192,452	183,171	167,725
Taxes other than income taxes	161,042	132,759	110,799	104,493	101,381
Income taxes	162,265	121,402	216,395	164,570	157,514
Rate deferrals:					
Rate deferrals	(785,897)	(236,676)	—	—	—
Income taxes	383,180	117,245	—	—	—
Total	2,323,667	2,522,408	2,592,621	2,439,313	2,397,225
Operating Income	1,162,245	716,051	553,414	470,344	449,039
Other Income:					
Allowance for equity funds used during construction	8,830	217,734	301,123	245,640	182,342
Miscellaneous income and deductions—net	76,403	80,120	18,090	6,799	7,133
Income taxes—credit	22,645	82,166	160,442	131,323	132,959
Total	107,878	380,020	479,655	383,762	322,434
Interest and Other Charges:					
Interest on long-term debt	692,980	697,853	636,390	529,597	488,750
Other interest—net	34,608	53,306	57,388	47,251	74,130
Allowance for borrowed funds used during construction	590	(146,680)	(235,873)	(180,858)	(170,438)
Preferred dividend requirements of subsidiaries	90,643	90,601	84,353	80,066	68,436
Total	818,821	695,080	542,258	476,056	460,878
Income Before Cumulative Effect of a Change in Accounting Method	451,302	400,991	490,811	378,050	310,595
Cumulative Effect to January 1, 1984, of Accruing Unbilled Revenues (net of income taxes of $16,548 thousand)	—	—	17,626	—	—
Net Income	$ 451,302	$ 400,991	$ 508,437	$ 378,050	$ 310,595
Earnings Per Average Common Share:					
Before cumulative effect of a change in accounting method	$ 2.21	$ 2.01	$ 2.76	$ 2.46	$ 2.33
Cumulative effect to January 1, 1984, of accruing unbilled revenues—net	—	—	0.10	—	—
Total	$ 2.21	$ 2.01	$ 2.86	$ 2.46	$ 2.33
Dividends Declared Per Common Share	—	$ 0.89	$ 1.75	$ 1.71	$ 1.67
Average Number of Common Shares Outstanding	204,581,092	199,496,115	178,083,867	153,383,044	133,193,296

Utility Plant and Capitalization (at December 31)

	1986	1985	1984	1983	1982
Fixed Assets:					
Utility plant	$13,470,037	$14,143,738	$13,294,825	$11,942,417	$10,464,188
Less—Accumulated depreciation and amortization	2,395,523	2,080,838	1,856,279	1,694,475	1,551,700
Utility plant—net	$11,074,514	$12,062,900	$11,438,546	$10,247,942	$ 8,912,488
Capitalization:					
Common equity	$ 4,354,426	$ 3,907,159	$ 3,472,246	$ 3,001,542	$ 2,481,916
Preferred stock (including premium and issuance expense):					
Without sinking fund	330,967	330,967	330,967	330,967	330,967
With sinking fund	508,165	467,293	476,928	429,601	354,957
Long-term debt (excluding currently maturing debt)	5,983,029	5,680,590	5,865,304	5,032,175	4,429,447
Total	$11,176,587	$10,386,009	$10,145,445	$ 8,794,285	$ 7,597,287
Capitalization Ratios:					
Common equity	39.0%	37.6%	34.2%	34.1%	32.7%
Preferred stock (including premium and issuance expense)	7.5	7.7	8.0	8.7	9.0
Long-term debt (excluding currently maturing debt)	53.5	54.7	57.8	57.2	58.3

Report of Management

The management of Middle South Utilities, Inc. has prepared and is responsible for the financial statements and related financial information included in this annual report. The financial statements are based on generally accepted accounting principles. Financial information included elsewhere in this report is consistent with the financial statements.

To meet its responsibilities with respect to financial information, management maintains and enforces a system of internal accounting controls which is designed to provide reasonable assurance, on a cost-effective basis, as to the integrity, objectivity, and reliability of the financial records and as to the protection of assets. This system includes communication through written policies and procedures, and an organizational structure that provides for appropriate division of responsibility and the training of personnel. This system is also tested by a comprehensive internal audit program.

The Board of Directors pursues its responsibility for reported financial information through its audit committee, composed of outside directors. The audit committee meets periodically with management, the internal auditors, and the independent public accountants to discuss auditing, internal control, and financial reporting matters. The independent public accountants and the internal auditors have free access to the audit committee at any time.

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

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

Auditors' Opinion

The Stockholders and the Board of Directors
of Middle South Utilities, Inc.:

We have examined the consolidated balance sheets of Middle South Utilities, Inc. as of December 31, 1986 and 1985, and the related consolidated statements of income, retained earnings, paid-in capital and changes in financial position for each of the three years in the period ended December 31, 1986. Our examinations were made in accordance with generally accepted accounting standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As discussed in Notes 2 and 8 of Notes to Consolidated Financial Statements, Louisiana Power & Light Company (LP&L) agreed to permanently absorb $284 million of the cost of Waterford 3 as part of an interim rate order issued by the Louisiana Public Service Commission in November 1985. A new accounting standard will require that this $284 million disallowance, less related tax benefits, be recognized as a loss by LP&L by 1988, the year in which the new standard becomes effective.

In our report dated March 14, 1986, except for Note 15 as to which the date was March 25, 1986, our opinion on the 1984 and 1985 consolidated financial statements was qualified as being subject to the effects on those financial statements of such adjustments, if any, as might have been required had the outcome of uncertainties concerning, among other matters, the receipt of adequate rate relief by LP&L been known. As discussed in Note 2 of the Notes to Consolidated Financial Statements, this uncertainty was resolved as LP&L received a rate order in January 1987 which will provide adequate rate relief. Accordingly, our opinion on the 1984 and 1985 consolidated financial statements, as expressed herein with respect to this matter, is different from that expressed in our previous report.

The accompanying consolidated financial statements include substantial investments in Grand Gulf 2, a suspended construction project, and in revenues deferred for future recovery. As discussed in Notes 2 and 8 of Notes to Consolidated Financial Statements, there are uncertainties regarding the recoverability of these investments in that the construction activities of Grand Gulf 2 are continuing to be suspended and there are challenges and/or potential reversals of certain of the System operating companies' retail rate orders which provide the basis for deferring revenue for future recovery. Also, a potential for debt acceleration exists under certain loan agreements if the rate structures providing for the recovery of Grand Gulf 1 costs are not adequately maintained.

In our opinion, subject to the effects on the above-mentioned consolidated financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainties referred to in the preceding paragraph been known, such financial statements present fairly the financial position of the Company and its subsidiaries at December 31, 1986 and 1985, and the results of their operations and changes in their financial position for each of the three years in the period ended December 31, 1986, in conformity with generally accepted accounting principles consistently applied during the period subsequent to the change, with which we concur, made as of January 1, 1984, in the method of recording revenues by one of the subsidiaries as described in Note 1 of Notes to Consolidated Financial Statements.

Deloitte Haskins & Sells

New Orleans, Louisiana
February 27, 1987

Investor Information

Annual Meeting
The 1987 Annual Meeting of Stockholders will be held at 10 a.m. (CDT) on May 15, 1987, at the Excelsior Hotel, Little Rock, Arkansas. A notice of the meeting and proxy material will be mailed on or about April 10, 1987, to stockholders of record on April 6, 1987. Stockholders of record may obtain a badge for admission to the meeting at the registration desk. Stockholders whose shares are held in street name, i.e., in the name of their broker, must present a letter from their broker indicating ownership of MSU common stock as of April 6, 1987.

Stockholders of Record
At the close of 1986, there were 131,905 common stockholders of record of Middle South Utilities, Inc. A total of 204,581,092 shares were outstanding.

Dividends and Reinvestment
The Board of Directors omitted declaring common stock dividends in the third quarter of 1985. The Directors and management of Middle South Utilities are committed to reinstating a quarterly dividend as soon as prudently possible, as stated in the Chairman's Letter of this report.

The Dividend Reinvestment and Stock Purchase Plan was terminated effective October 24, 1986, by action of the Board of Directors.

Stockholder Inquiries
All correspondence concerning stockholder records should be directed to:

Middle South Utilities, Inc.
Stockholder Services
P.O. Box 61236
New Orleans, Louisiana 70161

Transfer Agent and Registrar
Morgan Shareholder Services Trust Company is the MSU transfer agent and registrar. All correspondence concerning the issuance or transfer of common stock certificates should be directed to:

Morgan Shareholder Services
Trust Company
Stock Transfer
30 West Broadway
New York, New York 10007-2192

Form 10-K Available
The Middle South Utilities System 1986 Annual Report to the Securities and Exchange Commission on Form 10-K (including financial statement schedules) is available to stockholders upon request. To receive a copy without charge, call or write to:

Dan E. Stapp, Secretary
Middle South Utilities, Inc.
P.O. Box 61005
New Orleans, Louisiana 70161
(504) 529-5262

Financial and Statistical Review
Historical statistics and financial information supplemental to the 1986 Annual Report and Form 10-K are available in the Company's 1986 Financial and Statistical Review, which will be available for distribution in June. Copies of the Review may be obtained by contacting Investor Relations at the address given in the following section.

Investor Relations
MSU conducts an active investor relations program to communicate the Company's performance to institutional investors, security analysts, registered representatives, and individual investors. Investor Relations may be contacted by writing or calling:

Middle South Utilities, Inc.
Investor Relations
P.O. Box 61005
New Orleans, Louisiana 70161
(504) 529-5262

Exchange Listings
The common stock of Middle South Utilities, Inc. is listed and traded on the New York, Midwest, and Pacific stock exchanges. The ticker symbol for the Company is MSU. Newspaper stock table listing is MidSUt.

Abbreviations:

In this report, references to companies in the Middle South Utilities System are as follows:

MSU/Company	Middle South Utilities, Inc.
System	The companies of the Middle South Utilities System, excluding Electec, Inc.
AP&L	Arkansas Power & Light Company
Associated	Associated Natural Gas Company
Electec	Electec, Inc.
LP&L	Louisiana Power & Light Company
MP&L	Mississippi Power & Light Company
NOPSI	New Orleans Public Service Inc.
SERI	System Energy Resources, Inc. (formerly Middle South Energy, Inc.)
SFI	System Fuels, Inc.
SSI	MSU System Services, Inc. (formerly Middle South Services, Inc.)

Directors and Officers

MSU DIRECTORS

William C. Battle
Retired President and Chief Executive Officer of Fieldcrest Mills, Inc., Ivy, Virginia; Chairman of the Board of W. Alton Jones Cell Science Center. Audit, Nominating, Personnel, and Public Affairs Committees.

James M. Cain
President of Louisiana Power & Light Company and of New Orleans Public Service Inc., New Orleans, Louisiana.

John A. Cooper Jr.
President of Cooper Communities, Inc., Bentonville, Arkansas. Executive, Finance (Chairman), and Nominating Committees.

Brooke H. Duncan
President of Foster Company, Inc., New Orleans, Louisiana. Executive, Finance, Nominating, and Public Affairs (Chairman) Committees.

Kaneaster Hodges Jr.
Attorney, Newport, Arkansas. Audit, Nominating, Nuclear, and Public Affairs Committees.

Edwin Lupberger
Chairman and President of Middle South Utilities, Inc., New Orleans, Louisiana. Executive (Chairman), Nominating, and Nuclear Committees.

Donald C. Lutken
Chairman and President of Mississippi Power & Light Company, Jackson, Mississippi.

Jerry L. Maulden
President of Arkansas Power & Light Company, Little Rock, Arkansas.

James R. Nichols
Partner of Nichols and Pratt (Family Trustees) and attorney, Boston, Massachusetts. Audit, Finance, Nominating, and Nuclear Committees.

LeRoy P. Percy
Cotton farmer; Chairman of the Boards of Mississippi Chemical Company and First Mississippi Corporation; President of Greenville Compress Company, Greenville, Mississippi. Executive, Nominating (Chairman) and Nuclear (Chairman) Committees.

Robert D. Pugh
Chairman of the Board of Portland Gin Company (agricultural and agribusiness); Chairman of Portland Bank, Portland, Arkansas. Executive, Nominating, and Personnel (Chairman) Committees.

H. Duke Shackelford
President of Shackelford Company, Inc., Shackelford Gin, Inc., and Louisiana Cotton Warehouse Company, Inc.; Chairman of Union Oil Mill, Inc. (agricultural and agribusiness), Bonita, Louisiana. Audit (Chairman), Nominating, and Personnel Committees.

Frank G. Smith
Vice Chairman of the Board of MSU System Services, Inc.; President and Chief Operating Officer of Electec, Inc., New Orleans, Louisiana.

Wm. Clifford Smith
President of T. Baker Smith & Son, Inc., Houma, Louisiana. Finance, Nominating, and Nuclear Committees.

Dr. Walter Washington
President of Alcorn State University, Lorman, Mississippi. Audit, Nominating, Personnel, and Public Affairs Committees.

MSU OFFICERS

Edwin Lupberger
Chairman and President. Age 50. Joined the MSU System in 1979. Sixteen years prior utility industry service.

William Cavanaugh III
Senior Vice President, System Executive—Nuclear. Age 48. Joined the MSU System in 1969.

Jerry D. Jackson
Senior Vice President, System Executive—Legal and External Affairs. Age 42. First joined the MSU System in 1979.

R. Drake Keith
Senior Vice President, System Executive—Finance, and Treasurer. Age 51. Joined the MSU System in 1983. Fifteen years prior utility industry service. (On March 1, 1987, Keith became an Executive Vice President for LP&L and NOPSI, and H. Stuart Ball was elected MSU Treasurer. A successor will be named to fill the MSU System Executive—Finance post.)

Jack L. King
Senior Vice President, System Executive—Operations. Age 47. Joined the MSU System in 1966.

H. Stuart Ball
Treasurer. Age 43. Joined the MSU System in 1985.

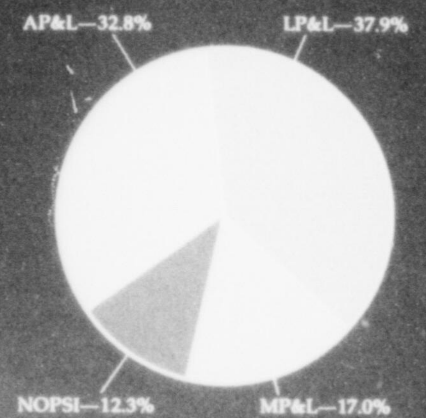
Dan E. Stapp
Secretary. Age 52. Joined the MSU System in 1958.

Dorothy M. Antoine
Assistant Secretary. Age 54. Joined the MSU System in 1952.

Middle South Utilities, Inc. is an investor-owned public utility holding company that owns all the outstanding common stock of four operating companies. Those companies are Arkansas Power & Light Company (AP&L), Louisiana Power & Light Company (LP&L), Mississippi Power & Light Company (MP&L), and New Orleans Public Service Inc. (NOPSI). Other subsidiaries of Middle South Utilities, Inc. are MSU System Services, Inc. (SSI), a service company; System Energy Resources, Inc. (SERI), a generating subsidiary; and Electec, Inc., a diversified subsidiary which markets the capabilities, expertise, and resources of the System companies.

System Fuels, Inc. (SFI) is a fuels procurement subsidiary of the four operating companies. Associated Natural Gas Company is a gas distribution subsidiary of Arkansas Power & Light Company.

Operating Companies' Contribution to Operating Revenues



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Post Office Box 61005
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