MIDDLE SOUTH UTILITIES, INC. ANNUAL REPORT [illegible]

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PERFORMANCE HIGHLIGHTS

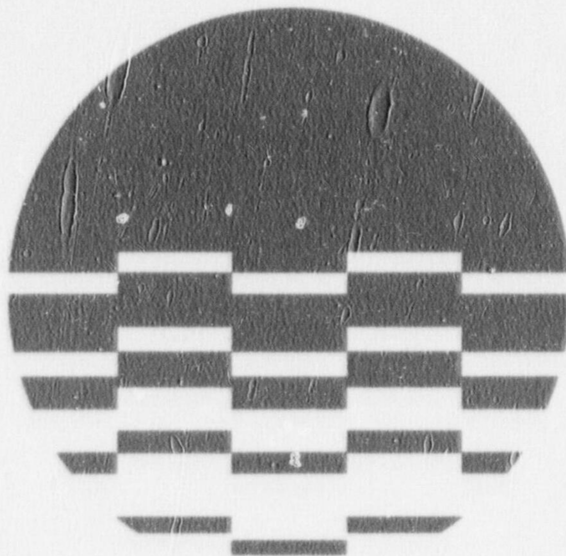
Middle South Utilities, Inc.

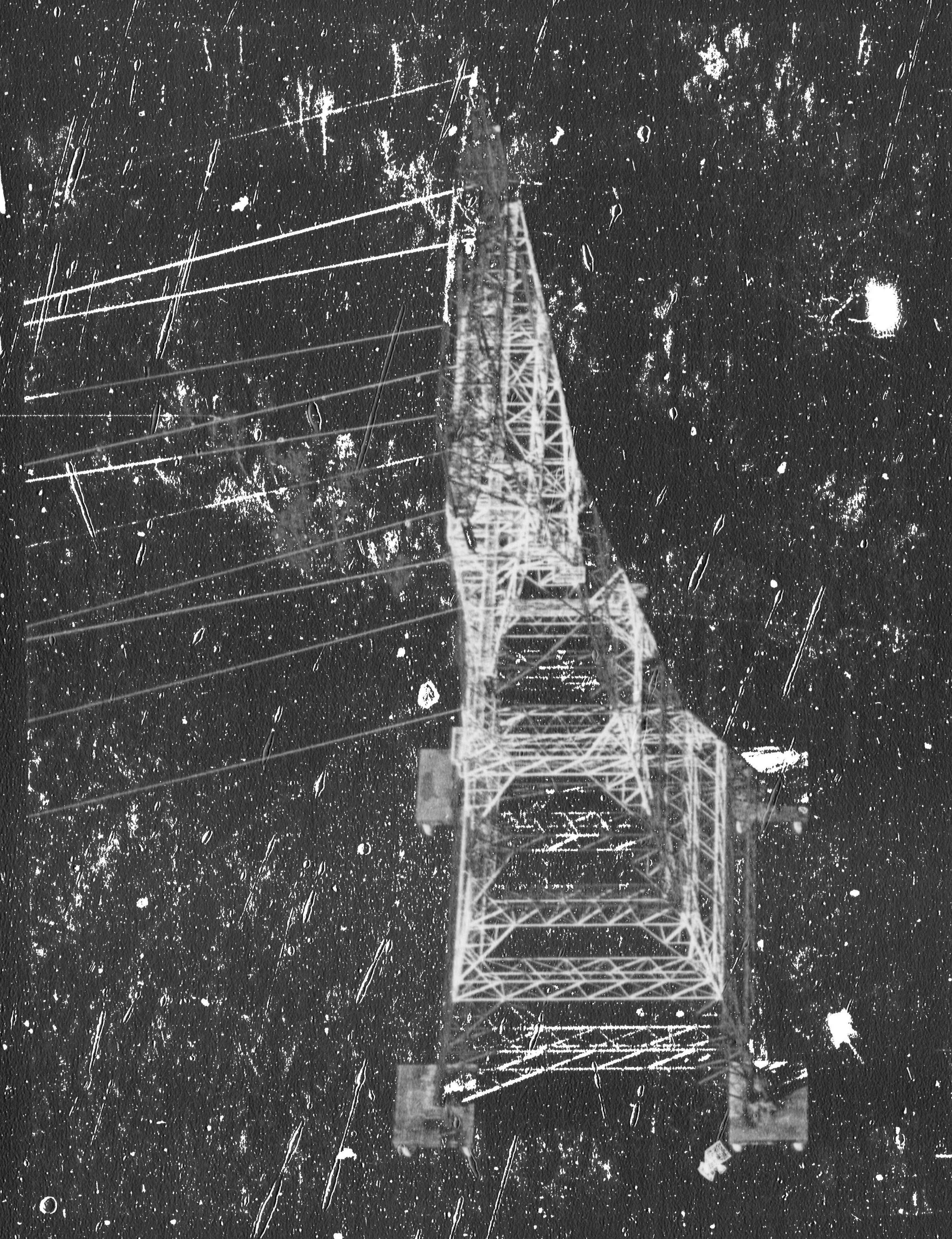
	1988	1987	% Increase/ (decrease)
Total operating revenues (millions)	$3,565	$3,455	3.2
Total operating expenses (millions)	$2,496	$2,445	2.1
Fuel, purchased power & purchased gas costs (millions)	$ 983	$ 982	0.1
Rate deferrals – net of write-off (millions)	$ 292	$ 333	(12.3)
Operating income (millions)	$1,070	$1,010	5.9
Net income (millions)	$ 411	$ 357	15.3
Rate of return on average common equity	8.72%	8.20%	6.3
Earnings per common share	$ 2.01	$ 1.74	15.5
Net utility plant at year-end (billions)	$ 11.1	$ 11.2	(1.1)
Construction expenditures (millions)	$ 350	$ 362	(3.3)
Retail electric customers at year-end	1,693,592	1,678,284	0.9
Retail electric energy sales (million kWh)	52,575	51,411	2.3
System peak load (megawatts)	11,442	11,270	1.5
Average number of common shares outstanding (thousands)	204,581	204,581	–

The "Entergy" shown emerging on the cover of this report is emblematic of the new direction being forged for this Company — a bold new direction embodied in a name.

Entergy combines the words "enterprise," "energy," and "synergy," three qualities that describe the Company's new approach to navigating the rapidly evolving energy marketplace.

At the 1989 Annual Meeting, stockholders will be asked to approve "Entergy Corporation" as the Company's new name. If approved, "Entergy Corporation" will be presented with the red symbol below to form a new Company logo, one spearheading a new graphic look for the entire Middle South Electric System.





MEETING THE CHALLENGE OF CHANGE

Middle South Utilities, Inc.

CHAIRMAN'S LETTER [illegible]

REGULATORY [illegible]

FINANCIAL 10

ORGANIZATIONAL 14

SOCIAL 18

Middle South Electric System 500-KV transmission lines cross the Mississippi River near Vicksburg

Dear Stockholders:

Nineteen eighty-eight was an exciting year. It began with oral arguments before the U.S. Supreme Court, and ended with resumption of stockholder dividends and planning for a new corporate image. In all respects, it was a year of successful responses to the challenges of change.

In many ways, the year began on June 24, 1988, when the U.S. Supreme Court handed down a favorable decision in our Mississippi Power & Light appeal. That victory broke through the uncertainty and conflict that had fettered us since our first attempt to collect rates for Grand Gulf 1, our System Energy Resources, Inc. subsidiary's nuclear unit. The Supreme Court decision not only affirmed our right to collect Grand Gulf rates, it also established the Federal Energy Regulatory Commission's exclusive authority to regulate wholesale electric rates — and established that states may not keep utilities from passing through to retail customers FERC-mandated wholesale costs.

With the issue of Grand Gulf rate collections resolved, the monies held in escrow pending the Court's decision were released, enabling the System to pay down its debts. The ensuing financial stability has resulted in improved ratings for System securities and has allowed the price of MSU stock to climb. Our prospects for less adversarial relations with our regulators are also improved. We can now set our sights on success — not just survival — in the rapidly changing electric utility marketplace. While a number of impediments to our progress remain, in 1988 we were freed to vigorously pursue the vision I announced last year.

That vision, "to become a customer-oriented, socially responsible, financially strong, successful competitor in the evolving electric energy business," calls for a different type of organization — different focus in leadership, different attitudes, and different ways of doing business — than those considered traditional in the utility industry. Like the banking, telecommunications, and airline industries before us, the electric utility industry is in the midst of regulatory upheaval that offers both opportunity and risk.

In the era we have entered, utilities are not guaranteed a fair return or even financial survival. Like any other business in the country, we can fail — as some have already demonstrated.

While we have always had to account for our actions, now the demands on utility performance are much greater; and that performance is being measured against the performance of neighboring utilities and competing suppliers.

We can count on fewer and fewer "captive" customers. We can no longer assume cost-based rates. We are working hard to keep customers "on the grid" — and that means stabilizing or reducing costs, improving service, assuring quality and reliability, and advertising our services just like competitors in any other business.

The changes we face impact many areas: regulatory, financial, organizational, and social. But rather than continuing to be buffeted by the forces now shaping the utility industry, the Company has begun capitalizing on these forces, adjusting to meet the challenges of change.

Our new strategic planning process, introduced last year, sets Systemwide goals, programs, and objectives, so that the efforts of each operating company directly contribute to the System's progress toward our vision.

The System has restructured its top management, assigning System Executive positions to Jerry Maulden, Arkansas Power & Light and Mississippi Power & Light chairman and CEO; James Cain, Louisiana Power & Light/New Orleans Public Service Inc. chairman and CEO; and Donald Meiners, MSU System Services, Inc. president and CEO, who are responsible, respectively, for Arkansas, Mississippi, and Missouri operations; Louisiana operations; and for System services.

The new responsibilities of the three new System Executives strengthen our Systemwide teamwork by bringing their subsidiary company concerns and their personal expertise to the System's top decision-making team.

As part of our new strategic planning process, each subsidiary company has examined its operations in exhaustive detail. We have established goals for reducing costs and improving efficiency in many areas. Each of the operating companies has reorganized for greater productivity — with fewer personnel. Although these workforce reductions have been painful, we have not faltered in taking the necessary steps — in as humane and constructive a way as possible.

We are also taking aggressive action to develop our markets — within our service area and beyond. Our System Strategic Plan has established ambitious marketing goals for recruiting new and expanding industries, retaining commercial and industrial customers at risk to alternative suppliers, including cogenerators, and gaining market share in our residential and commercial markets.

We are also taking advantage of our strategic location and well-developed transmission system to sell power to utilities beyond our franchise area. And, along with others in the industry, we are taking an active role in FERC's proposed rule changes — to ensure that the resulting transmission policies, and pricing, are fair and reasonable.

Another major initiative introduced in 1988 is Project Olive Branch — so named because its purpose is to rebuild relationships with our customers and regulators. We recognize that the conflict and litigation of the last few years have been detrimental to all concerned. Even though our position was upheld by the Supreme Court, we know that our continued success depends on the goodwill and confidence of those who regulate us and those we serve.

More than just a conciliatory attitude, Project Olive Branch is a series of programs aimed at reducing costs, stabilizing rates, and thereby improving relationships with our customers and local regulators, while at the same time building stockholder value. In 1988, we announced two major components of Project Olive Branch: the planned consolidation of our nuclear operations management under System Energy, and the sale/leaseback of a portion of Grand Gulf 1. As we describe in the "Financial Change" and "Organizational Change" sections of this report, both of these initiatives are bold, forward-looking programs to lower costs, boost efficiency, save money, and give both customers and stockholders more for their money.

On every front — political, regulatory, financial, organizational, and social — we are changing to meet the challenges of a rapidly evolving electric utility industry. Emblematic of the changes we have made is the Company's new logo. The red Systemark, which in the past year has been used as an emblem of Systemwide teamwork, is now the symbol we present to the world, as well. Its use by all of the Company's subsidiaries, as well as the parent company, reinforces that we are all part of one System, supplying electric energy to the Middle South and beyond.

Also symbolic of the Company's new direction is our proposal to adopt a new name for the Company: Entergy Corporation. Comprising the words "enterprise," "energy," and "synergy," Entergy aptly describes our revitalized Company — its new attitude, assertiveness, and adaptability.

The operating company subsidiaries, which, along with the parent company, will continue to be identified collectively as "The Middle South Electric System," will not change their names. The System's service company, MSU System Services, Inc., would, however, become Entergy Services, Inc.

Last, but certainly foremost in the eyes of our stockholders and the investment community, 1988 was the year we resumed dividend payments, after three long, difficult years. Our goal in 1989 and beyond, indeed, one of the primary reasons we are in business, is to build the level of those dividend payments and reward your long-standing faith in us.

Sincerely,

Edwin Lupberger
Chairman and President
March 15, 1989

Deregulation. Competition. The electric utility industry at a crisis point brought about by the changes of the last 10 years: the oil embargo, high inflation, increased costs, and reduced demand. Unraveling of the regulatory compact. Obligation to serve without a corresponding obligation to pay. Prudence reviews. Disallowances. A trend to let "market conditions" determine rates. A more active wholesale market. Vertical disintegration of the industry into separate generating, transmission, and distribution companies. Litigation over the proper boundaries between state and federal regulatory jurisdiction. Competition among electric utilities. Competition between utilities and independent power producers. Pressure for increased access to transmission lines. A new era characterized by risk and reward, rather than by the stability and control of years past.

Reflecting the Company's involvement in the governmental arena, MP&L's Bill Cossar talks with Mississippi Lieut. Gov. Brad Dye, in the Jackson Capitol.

Middle South Utilities is moving decisively toward the kind of utility industry leadership described by Chairman and President Edwin Lupberger in his Company vision, announced last year. That vision issued a directive: "During the next decade, the Company will become and be widely recognized as a customer-oriented, socially responsible, financially strong, successful competitor in the evolving electric energy business."

That leadership responsibility includes a more active, effective role in the regulatory and political arena that so profoundly affects the nation's investor-owned electric utilities. Uncertainties currently facing the industry can become opportunities if we present our viewpoint to regulators and policy-makers more persuasively than in the past.

The most important demonstration of our renewed effectiveness came on June 24, 1988, when the U.S. Supreme Court decided MP&L's appeal in our favor. Our high court victory not only enabled the collection of Grand Gulf rates, it also resolved — in an emphatic way — the issue of who is responsible for regulating wholesale electricity rates.

The resolution of this issue has cleared the way for resolution of many other obstacles in the System's path:

- System Energy Resources, Inc., our subsidiary that owns and operates Grand Gulf 1, was able to recover the monies held in escrow and has been able to pay down its bank loans.
- The uncertainty over Grand Gulf rate collections has been eased, lowering financing costs across the System and allowing our common stock price to climb.
- System attorneys, arguing our New Orleans Public Service Inc. subsidiary's case before the U.S. Supreme Court and Louisiana state courts, can rely on stronger legal precedent.
- Future dealings with local regulators will not be clouded by questions of jurisdictional authority.

Building on the momentum of this victory, the Company is positioning itself to capitalize on increased access to the wholesale electric market. The Federal Energy Regulatory Commission has proposed several rule changes that would boost competition in the electric utility industry. The first proposal offers states and utility companies the option of competitive bidding for new generating capacity. New plants could be built by the lowest qualified bidder.

The second proposal streamlines regulations pertaining to independent power producers, and establishes a bidding or negotiation process for IPP rates, rather than traditional cost-of-service regulation. The third proposal halts the practice of forcing utilities to make capacity payments to cogenerators for capacity they don't need.

Middle South Utilities has testified on behalf of the commission's proposed changes, which, if structured properly, would expand utilities' options for providing for future electricity needs flexibly and efficiently. FERC's proposals are the most recent indication of a trend toward "vertical disintegration" of the industry: separation of the electricity generation and transmission business from

"Delivering the volts" to the 1988 GOP Convention gave the Company a chance to shine in the national spotlight.

The U.S. Supreme Court established the Company's right to collect FERC-allocated Grand Gulf rates.

the local electricity distribution business.

This separation would make it possible for a company like ours to engage in both types of activities, but with different rules in effect for each.

For example, the Company would continue to generate, transmit, and distribute electricity through its state-regulated operating companies — AP&L, MP&L, and LP&L. The Company could also bid to build and operate a generating plant for a utility in need of power — doing so as an independent power producer. The capital put at risk to build the plant would be jeopardized only if we failed to honor our contractual agreements, subject to review by FERC. It would not be directly exposed to local opposition to rate increases at the retail level. Further, the competitive bidding process would help ensure that only cost-effective projects are built, and would reassure customers that costs incurred are prudent.

This was essentially what we proposed to do last year for Florida Power & Light — become an independent power producer. With a consortium of partners, we offered to invest our coal-plant equipment and expertise in a plant to be built in the Bahamas. The electricity generated would be sold to the Florida utility.

Although this project did not materialize, it — or others like it — may eventually find a buyer. When it does, the Company will find another market for its product — one free from some of the regulatory restrictions on our operating company subsidiaries.

The Company is also working diligently to rebuild its relationships with local regulators, and to more effectively articulate its position at all levels of the political and regulatory process. Project Olive Branch is the name we have given to this rebuilding effort. In addition to our willingness to put the conflicts of the past behind us, Project Olive Branch includes substantive programs intended to lower costs, replace litigation with negotiation, and build goodwill as well as stockholder value.

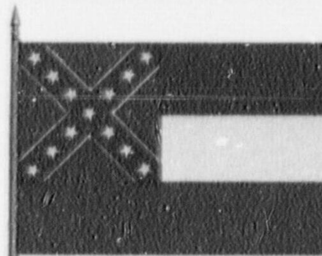
Two Project Olive Branch initiatives have already been announced: the sale/leaseback of Grand Gulf (see "Financial Change") and the consolidation of nuclear operations under System Energy (see "Organizational Change"). In the coming year, Project Olive Branch initiatives will embrace all facets of our operations: regulatory, financial, organizational, and social.

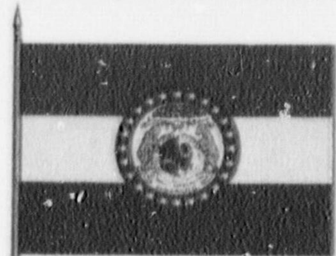
We are also building our political muscle in another, more personal way. Employees at each company are organizing grassroots political groups. These groups educate employees on issues, hold candidate forums, and communicate with elected officials. Although the groups are young — the oldest is little more than a year in operation — they are already having a noticeable effect on local politics.

Stockholders are being included in the Company's grassroots efforts, as well. Like the employee programs, a stockholder grassroots program, now being developed, will help keep stockholders informed about issues affecting the Company and the electric utility industry. This information will not only help make stockholders more knowledgeable investors, but, we hope, will make them more informed and active participants in the political process — especially as it affects electric utilities, and particularly, the Middle South Electric System.

These are but a few of the ways that the Company is raising its profile in the changing regulatory and political arena in which we operate. By taking an active role, we believe we can make a difference in whether the changes shaking the industry work for us — our stockholders and customers — or against us. We are already feeling the positive results of our efforts, and we will keep you informed of our results.

The June 24 U.S. Supreme Court decision made headlines and signaled the Company's turnaround.

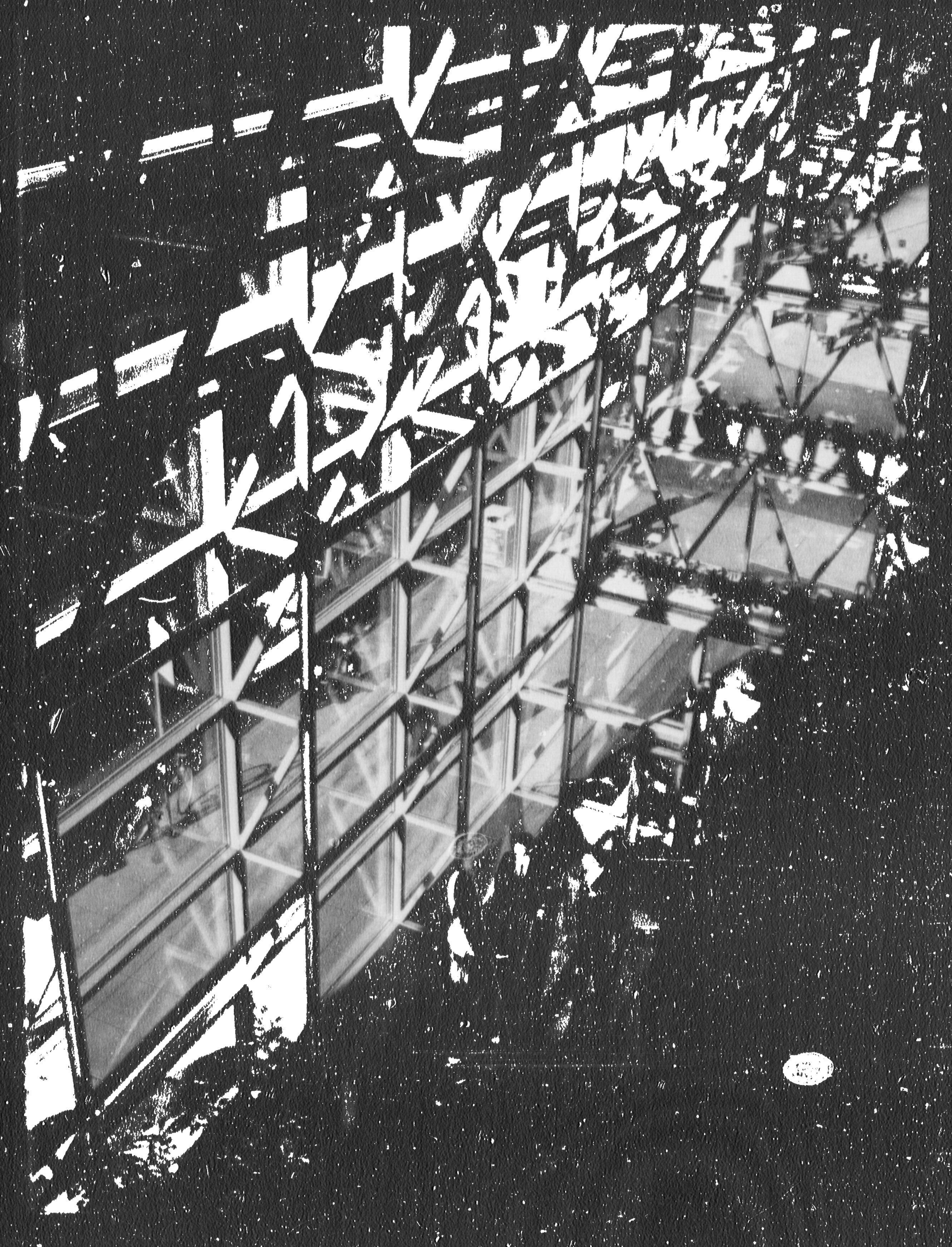




Regulatory relationships in Arkansas, Louisiana, Mississippi, and Missouri are being rebuilt through "Project Olive Branch."

Utility bankruptcies. Plant closings. High interest rates, reflecting regulatory and financial uncertainties. Competitive pressures to reduce costs. Reluctance to invest in high-cost, long lead-time projects. Conflict between ratepayers and stockholders. Loss of dividends. Loss of stockholder loyalty. A higher percentage of institutional investors and "computerized" stockholders. Mergers and acquisitions. Municipal buyouts. The threat of takeover. Utility diversification. Efforts to minimize debt and buy back stock. A search for new financing options. Sale and leaseback of generating facilities. High-stake business strategies. Risk and reward versus cost-based rates. The fundamental question for utility companies: whether to bet their financial future on more regulation or more competition — or some mix of both.

As part of the System's refinancing efforts, MSU Treasurer Stuart Ball meets with leading New York bankers.



The changes of the last 10 years have pushed a number of utilities to the brink of bankruptcy — where at least one has tumbled over. Middle South Utilities was pushed very nearly to that brink, from 1985 until June 24, 1988; but with our 1988 victory at the U.S. Supreme Court, a stream of life-giving revenues has been assured. The Company's investment ratings have improved. Stock prices have climbed out of the cellar. Dividend payments have resumed.

These are significant rewards for our last three years' work on maintaining Grand Gulf rates. Nevertheless, they are only the beginning. In fulfilling our commitment to becoming a financially strong, successful competitor, we are pursuing innovative and aggressive strategies to lower costs and increase the value of our operations for both customers and stockholders.

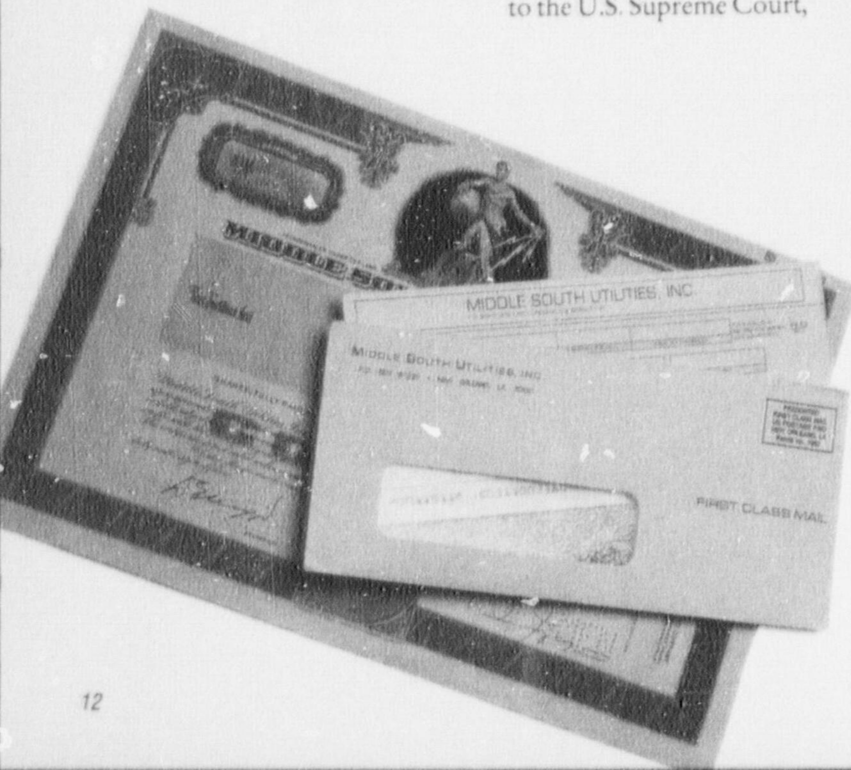
The Grand Gulf payments held in escrow, pending our appeal to the U.S. Supreme Court, have been released, enabling System Energy to pay down debts and refinance certain of those that remain. For example, prior to the Supreme Court decision, System Energy had approximately $285 million of "floating rate" pollution control revenue bonds. Not only did the rate on these bonds fluctuate with market conditions, the bonds could be returned to System Energy annually for refund by the bondholders. The U.S. Supreme Court decision, however, enabled System Energy to obtain fixed rates on approximately $256 million of its PCRBs, eliminating both the risk of rising rates and of bondholders causing a large cash drain by returning the bonds for refund.

Middle South Chairman and President Edwin Lupberger, accompanied by key System executives, personally met last fall with the nation's top rating agencies to campaign for better credit ratings.

The top three agencies raised the ratings on the System's senior debt and preferred stock following the U.S. Supreme Court decision. Moody's Investors Service, Inc. again raised ratings for AP&L, MP&L, and System Energy securities following approval by the Arkansas and Mississippi Public Service Commissions of revised Grand Gulf rate phase-in plans. The revised plans conform to new accounting rules issued by the Financial Accounting Standards Board.

The sale and leaseback of a portion of Grand Gulf 1 is expected to save millions over the life of the plant.

On December 1, 1988, the Company paid its first quarterly common stock dividend in more than three years.



System Energy's improved debt ratings also made it possible to renegotiate the company's nuclear fuel financings. Early in 1989, System Energy obtained new financing that will reduce by $4.5 million a year its fuel financing charges alone.

In addition to paying down and refinancing debt, in 1988 the Company also began pursuing more aggressive, innovative means to lower costs to customers and increase returns to stockholders. The December 1988 sale and leaseback of a portion of System Energy's Grand Gulf 1 generating facility is an example of these efforts.

Under the sale/leaseback plan, System Energy sold a 12.8 percent portion of its 90 percent share of Grand Gulf 1 to private investors for approximately $500 million cash, which was used primarily to pay off some of the high-interest first mortgage bonds that financed the unit's construction. System Energy continues to operate the plant, leasing back for the next 26 years the shares of the plant sold to the private investors.

The plan is expected to produce savings of about $40 million its first year, and as much as $150 million in current dollars over the life of the plant. Other sale/leaseback arrangements are being considered.

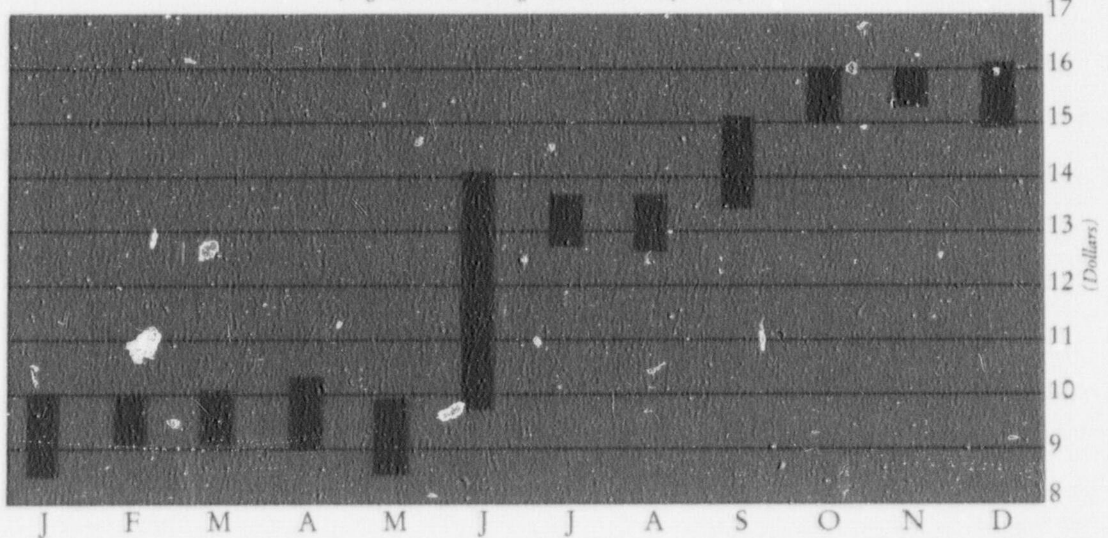
The sale/leaseback of Grand Gulf 1 is among the Company's first tangible demonstrations of Project Olive Branch, our program to repair relationships with the System's regulators and customers. The costs saved by the sale/leaseback are expected to lower costs for ratepayers — making our regulators' jobs easier — and improve earnings for stockholders.

Our participation in negotiations for a possible sale of NOPSI facilities to the City of New Orleans is another demonstration of Project Olive Branch at work. Such a sale offers the potential to resolve the litigation and regulatory controversy between NOPSI and the City of New Orleans in a manner beneficial to our customers as well as our stockholders. Negotiations are proceeding cautiously — as is to be expected in an asset transfer of this size — but representatives on both sides of the bargaining table remain hopeful that an agreement can be reached.

The resumption of dividend payments by the Company is, for our stockholders, the most concrete evidence of the financial changes we have made — and of our improved prospects. We said that 1987 was a pivotal year: we positioned ourselves for the positive U.S. Supreme Court decision we hoped 1988 would bring. In 1988, that decision came, bringing us the opportunity to demonstrate our abilities in the changing electric utility industry. We are confident that the future will bring additional changes. We are ready for them.

Middle South Utilities Common Stock

(High and Low Closing Prices Per Month for 1988)



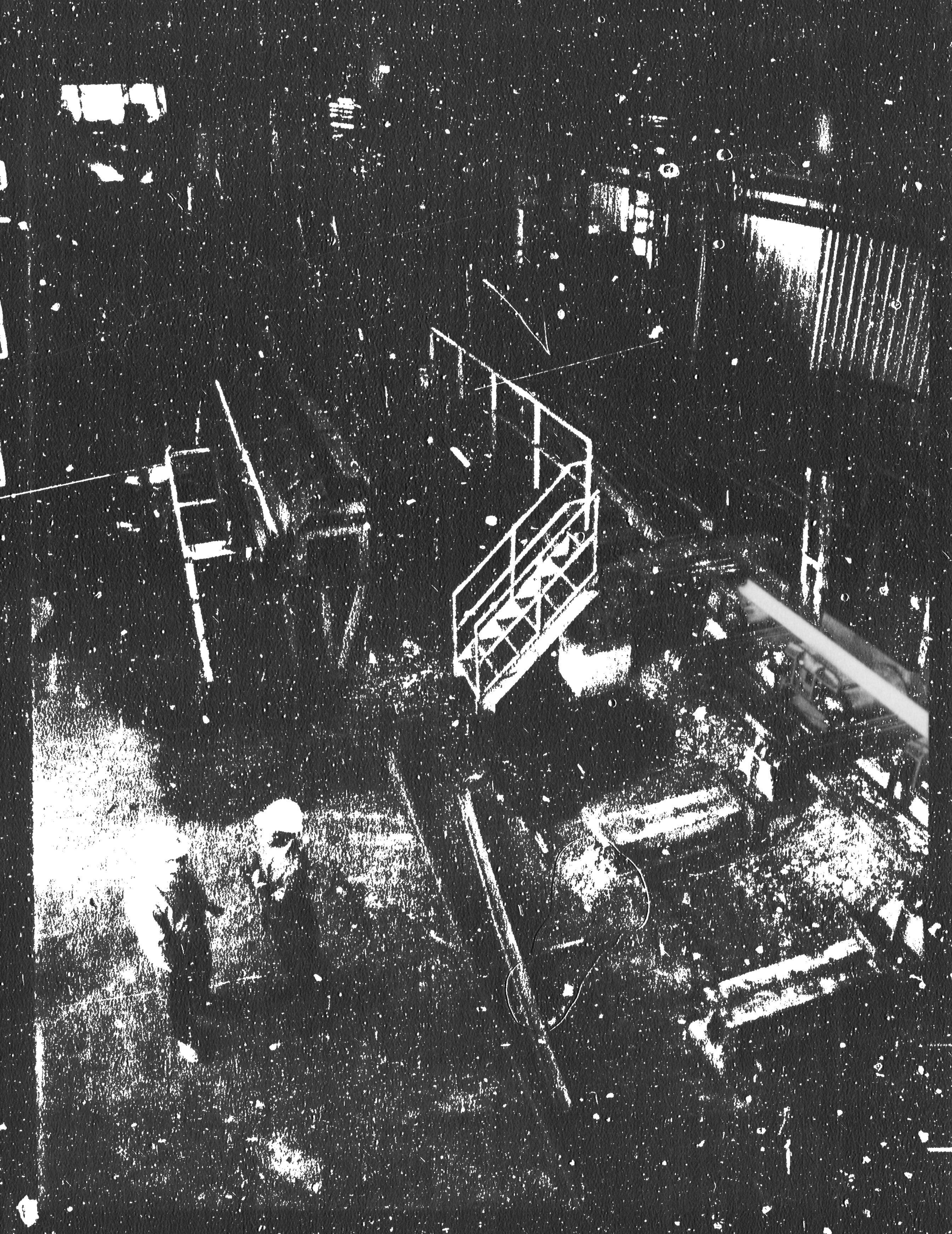
In 1988, MSU stock posted the greatest price increase of any investor-owned electric utility.

If stockholders approve the Company's new name, the new stock symbol will be "ETR."

MSU·ETR

An industry in flux — quickly moving away from regulated monopolies and restricted markets. Competition. One in four large utilities forced to cut costs. Few willing to risk new plant construction. Greater emphasis on efficient plant operations. Organizational reshuffling. Diversification. Greater emphasis on marketing and off-System sales. Proposals to break up the industry into separate generation, transmission, and distribution companies. Growing options for customers: conservation; cogeneration; photovoltaics; competing utilities; independent power producers; municipalization. Threat of large customers leaving the grid. Pressure to achieve low-cost producer status. Company downsizing and restructurings. Working to do more with less.

An example of the System's renewed emphasis on marketing and customer service: Ed Bailey, AP&L marketing rep, right, meets with Joe Karr, president of SMI Steel, Magnolia, Arkansas.



We believe that the forces sweeping the electric utility industry make clear that "business as usual" is no longer an effective strategy for success. In fulfilling our commitment to become "a customer-oriented, financially strong competitor," the Company is systematically changing the way it does business — to lower operating costs, improve service to customers, and provide a better return for our investors.

To do this means more than adopting a new corporate attitude. Becoming a successful competitor has meant taking a good, hard look at our organization — from the number of employees and their compensation, to the cost-effectiveness of our operations — our entire way of doing business.

In the last two years, each subsidiary company has examined its organizational structure to identify opportunities for improvement. That examination has led to "downsizing," or workforce reductions.

In 1987, AP&L completed an 11 percent workforce reduction that resulted in 553 fewer positions and an annual payroll savings of $19 million. LP&L and NOPSI have been consolidating their operations for the last several years. Upon completion of nuclear consolidation under System Energy, their efforts will have culminated in a 15 percent reduction in the companies' workforce.

MSU System Services, Inc., our service company, in 1988 began a restructuring that resulted in a 22.5 percent reduction in approved positions, and an annual savings of $9 million to $11 million. MP&L also announced plans to reorganize to meet future operating environments and competitive challenges. This is in addition to a two-year hiring freeze that keeps MP&L's employee-to-customer ratio the lowest in the System.

At the highest level, restructuring has meant adding new responsibilities to three System Executives and organizing System operations into new divisions encompassing Arkansas, Mississippi, and Missouri; Louisiana; and System services.

Jerry Maulden, AP&L and MP&L chairman and CEO, is now the System Executive responsible for Arkansas, Mississippi, and Missouri operations; James Cain, LP&L/NOPSI chairman and CEO, is responsible for Louisiana operations; and Don Meiners, SSI president and CEO, oversees System services. These subsidiary company CEOs join other System Executives responsible for the finance, legal and external affairs, operations, and nuclear areas, and strengthen the intercompany teamwork essential to the smooth functioning of the System.

Our restructurings are more than just cost-cutting measures. Functional consolidations have also resulted in a more agile, responsive organization — one that can quickly adapt to changing circumstances.

Map to the future: 500 KV transmission routes provide increasingly valuable access to markets beyond our service area.

Symbol of performance: Middle South's Chairman's Award recognizes excellence in individuals, teams, and companies.

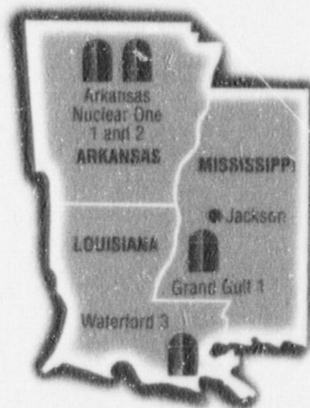
The most recent example is the proposed consolidation of nuclear operations under System Energy, currently awaiting regulatory approval. By consolidating the System's nuclear operations under one company, the System plans to increase management focus on nuclear safety, streamline nuclear operations and support activities, eliminate duplicate job functions, utilize personnel more efficiently, share information and expertise more readily, reduce reliance on outside vendors, and create a greater "esprit de corps" among the System's nuclear personnel. Savings of $23 million annually in operating and maintenance expense have been projected once consolidation is complete. An additional $6 million in capital savings are anticipated.

The Company has set additional cost-cutting goals for nuclear fuel and non-fuel operation and maintenance expenditures — including administrative and general overheads. In fact, employee and manager pay raises are now tied closely to departmental performance, including cost performance. We are making clear to employees, customers, and regulators our awareness that the old cost-recovery form of rate-making can be a recipe for failure if our costs outpace those of our competitors. We are rapidly adopting a cost-conscious, performance-oriented attitude designed to make sure our prices remain competitive.

Another aspect of successful competition is effective marketing. We are actively selling electricity's benefits as an energy source. Futhermore, we are marketing our electric capacity beyond the Middle South region to utilities in need of power.

We are also marketing the capabilities of the Middle South Electric System, as a whole. Through our commercial chain account program, for example, System marketing personnel are calling on the corporate offices of companies doing business in the Middle South, so that we can coordinate our solutions to all their energy needs. A decision to go all-electric, for example, can be implemented at each of their stores or offices throughout the region.

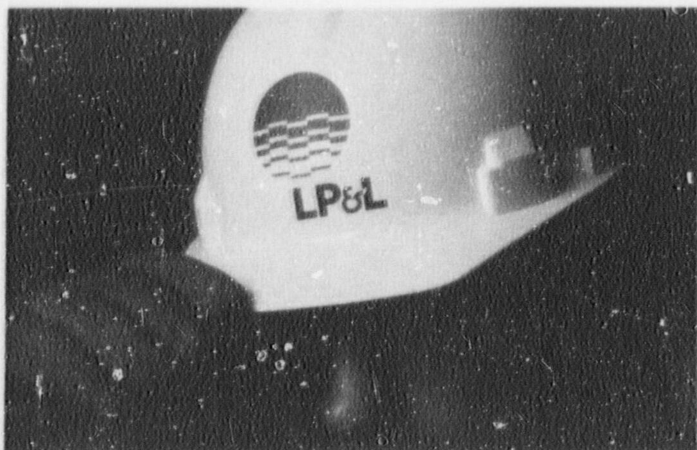
While commercial sales are being developed, the System has set aggressive marketing goals in the industrial sector, as well. A portion of these goals will be met through the retention of load at risk to cogeneration and alternative suppliers. LP&L, for example, has successfully competed against several proposed cogeneration projects, and has begun negotiating agreements with major customers to retain more than 1,400 megawatts of demand.



Streamlining operations and reducing costs, the System proposes a consolidation of nuclear operations.

Ambitious industry recruitment goals have also been implemented. Economic development efforts under way in Arkansas, Louisiana, Mississippi, and Missouri are expected to attract new industries to the Middle South and to develop local industries with prospects for success. These efforts could add substantially to the System's load in the next five years.

We were on the brink of bankruptcy; we're back now. We were perceived as insensitive to our customers' needs; we're seeking to better demonstrate the concern we have always felt for our customers. Like the utility industry in general, we were thought to be staid, bureaucratic, incapable of surviving in "the real world" of competition. Today we're flexing our competitive muscles and finding them capable of taking us the distance — even of leading the evolving electric utility industry.

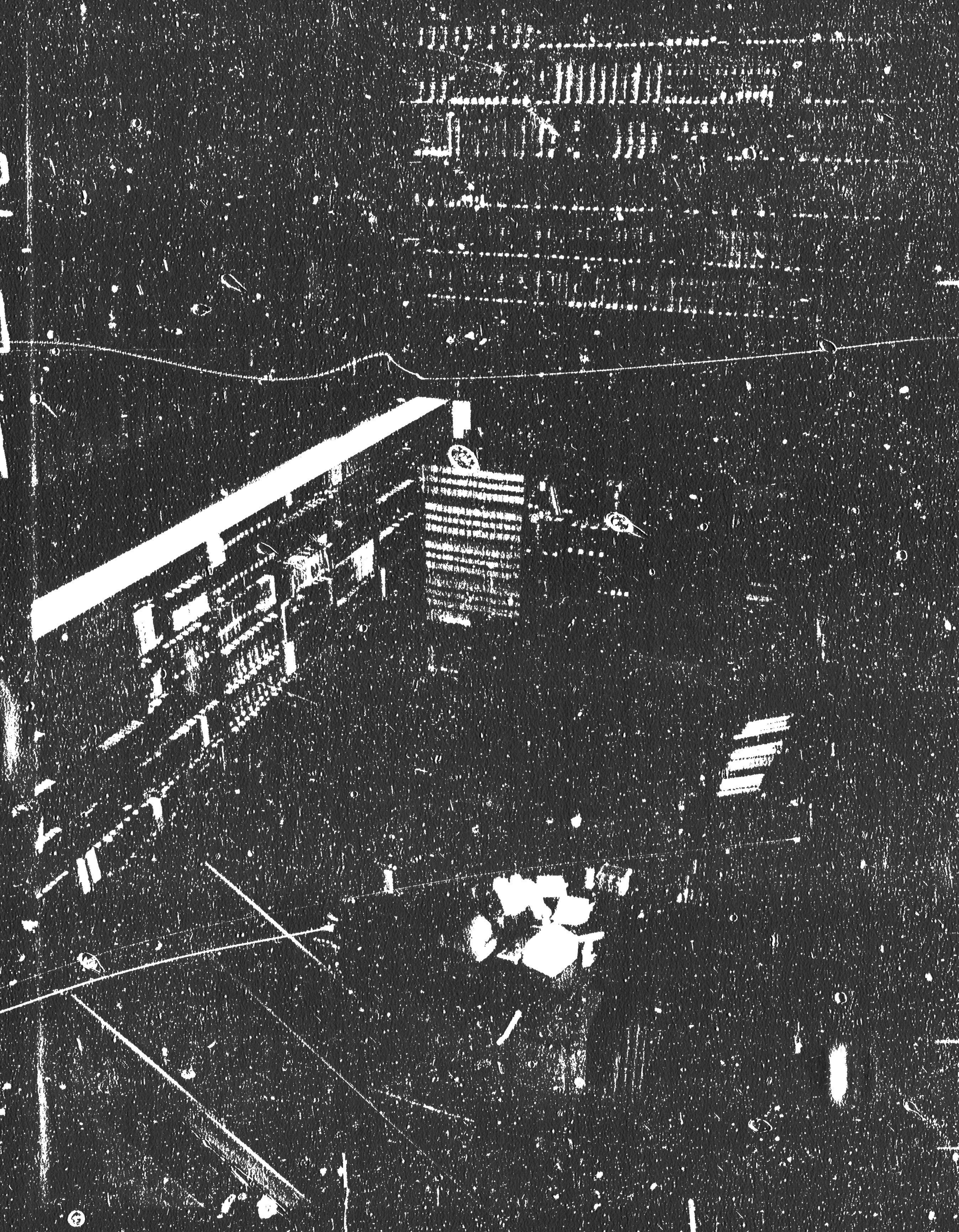


An LP&L lineman sports his company's new logo.

The color of excellence: members of the year's best operating shift at each of the System's nuclear plants were awarded red jackets.

Unemployment. Illiteracy. A shrinking tax base. Little funding for public schools. Government deficits. Crumbling infrastructure. Foreign competition. Overdependence on a few large industries — now in a slump. Lack of confidence. Lack of training. Lack of investment capital. Overburdened state and local governments. Into this environment add three young governors with a commitment to education. A commitment to integrity and fiscal responsibility. A belief in the ability of the region to pull itself up. Formation of the Delta Development Commission to study economic and social needs. Unique opportunities for public and private partnerships. Regional cooperation. Transforming the Middle South into an area of opportunity.

Zelma Randle, left, and Miriam Menard have teamed up against illiteracy through NOPSI's Operation Mainstream, one of the System's many literacy programs.



The Middle South Electric System is a proud sponsor of the region we serve. As the Company's vision states, we are as committed to being "socially responsible" as we are to being a "financially strong" competitor. Happily, we don't see the two goals as counteractive. As our region grows, so does its demand for electricity. As its economic indicators rise, so do ours. As the education of the workforce improves, so does that of our labor pool. As community opinion of our Company becomes more positive, so do our relationships with our regulators.

"Right now, the Middle South has an unprecedented opportunity for growth and development," says MSU Chairman and President Edwin Lupberger. "With Governors Clinton, Mabus, and Roemer cooperating on the region's behalf, the Delta Development Commission focusing federal attention on a significant portion of the region, and the private sector demonstrating a willingness to back the region with dollars and expertise, I don't believe there's anywhere we can go but up."

Prospects for the Middle South were encouraged by the Tri-State Governors' Agreement, signed last May by three of the region's governors (Clinton of Arkansas, Mabus of Mississippi, and Roemer of Louisiana). The pact commits the three states to cooperate in attracting investors, finding markets for the region's products, and developing the educational, transportation, and other systems that support economic development.

Last summer's successful Mid-South Trade Mission to Japan was the first joint activity resulting from the pact. Lupberger accompanied the governors on their trip, which greatly impressed the Japanese, who had never before seen three states work together as a team to promote their region.

The governors met with Prime Minister Noboru Takeshita, U.S. Ambassador Mansfield, and with key business and financial leaders, including executives of Sony, Toyota, and Nomura Securities, one of the world's largest securities firms. A press conference in Tokyo attracted five television stations and 35 reporters.

The trip was not the Company's first trade mission to the Orient, however. System economic development specialists have met with business leaders in Japan, Taiwan, and South Korea, and with prospective investors from Italy, Germany, Austria, Belgium, and Yugoslavia to discuss the region's development capabilities. More than 2,000 foreign firms that have expressed an interest in doing business in the U.S. have been contacted as a result of the Company's business development programs.

The region's potential consists of its fisheries and seafood industries, timber and agricultural resources, its transportation infrastructure and New Orleans' port, its

MSU Chairman Edwin Lupberger reads with children at Palmer Elementary School — one of the Company's partners in education.

"Christmas in the Oaks" has become a New Orleans tradition, sponsored by New Orleans Public Service Inc.

central location as a distribution hub, and its resource base for the petrochemical, plastic and resins industries, the pulp and paper, food, aircraft and aerospace, and medical and surgical supply industries.

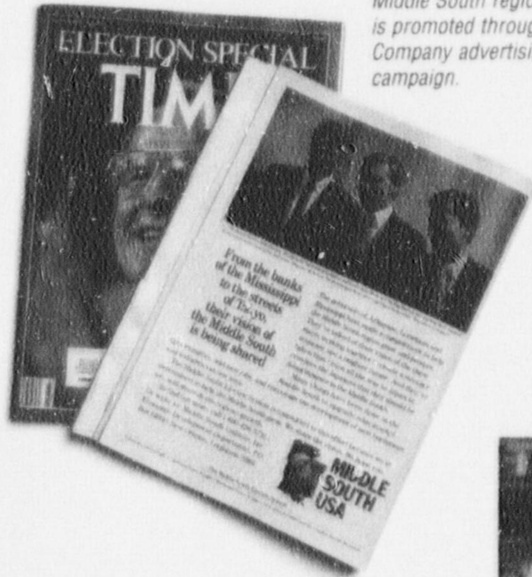
It also includes the Company's capabilities as one of the nation's largest electric utilities, with operating companies and competitive rates in each state of the Middle South, and a willingness to work with any company interested in the region.

In addition to trade visits and personal follow-up with investors, in 1988 the Company began an advertising campaign to promote the region as a fertile ground for growing businesses. The ads, which were the Company's first since 1985, appeared on television, in local and selected national business publications, and in a number of Japanese business publications.

The Middle South Electric System is also undertaking the nuts and bolts of industrial recruitment. In fact, operating company efforts are expected to contribute to at least 25 percent of all the new jobs created in the Middle South.

Recognizing education as a prerequisite to economic growth, the Company sponsors a number of "New Opportunities" programs that have made impressive gains toward improving the area economy and reducing illiteracy in the region. Perhaps the most notable is PALS (Principle of the Alphabet Literacy System), an interactive computer system that enables one tutor to simultaneously teach 16 individuals to read. Specifically designed for functionally-illiterate adults, PALS increases the average student's reading level by three grades in 20 weeks.

The Company has sponsored the installation of four PALS learning centers in New Orleans and Monroe, Louisiana; Jackson, Mississippi; and Helena, Arkansas. The centers will handle 640 people a year, once they are fully operational. First Lady Barbara Bush visited New Orleans' PALS laboratory last year, and commended the program for its contribution to adult literacy.



Economic development in the Middle South region is promoted through a Company advertising campaign.

On the economic development front, the Company regularly sponsors entrepreneurial skills workshops where small-business owners can gain practical advice on how to set up and manage a successful, growing business. More than 600 people have attended the workshops to date.

Last year, the Company also sponsored a business incubation institute in New Orleans. Business incubators are low-cost start-up facilities where new businesses can share support services and office space while they are young and financially vulnerable.

In short, we at Middle South Utilities understand that our future is inextricably linked with the region we serve. We are doing everything in our power to help the region, our customers, employees, and stockholders reach their full potential.

Community support is demonstrated by Company sponsorship of United Way advertising.

The Company's entrepreneurial workshops enrich small-business owners like Clarence Moret, of New Orleans Diesel.

Financial Condition

In 1988, the Middle South Electric System (System) made considerable progress in resolving certain of its legal and regulatory difficulties, when, on June 24, 1988, the U. S. Supreme Court rendered a decision (June 24 Decision) which affirmed Mississippi Power & Light Company's (MP&L) right to recover from its retail customers as reasonable operating expenses the costs of Unit 1 of the Grand Gulf Station (Grand Gulf 1) capacity and energy allocated to MP&L by the Federal Energy Regulatory Commission (FERC). The June 24 Decision thereby upheld the principle of federal preemption, which is necessary to secure implementation of System Energy Resources, Inc.'s (System Energy) federally mandated wholesale rates through the retail rate structures of the System operating companies. (See Note 2 – "Rate and Regulatory Matters.") The removal of this uncertainty strengthened the System's financial position, made possible the resumption of Middle South Utilities, Inc. (the Company or MSU) common stock dividends, and has resulted in a more favorable financial market for System financing activities.

On each of September 30, 1988, and January 27, 1989, the MSU Board of Directors declared a common stock dividend of 20 cents per share, payable on December 1, 1988, and March 1, 1989, respectively. Prior to December 1, 1988, MSU had last paid a common stock dividend in July 1985. Dividends on common stock had been omitted during the interim period due to the major uncertainties facing the System.

In December 1988, System Energy consummated certain arrangements relating to the remarketing of two series of outstanding pollution control revenue bonds, previously secured by letters of credit, on a long-term unsecured basis, prepaid in full amounts remaining outstanding under its bank loan agreements, and paid a cash dividend on its common stock of $300 million to MSU. This dividend was the first ever paid by System Energy. For further information regarding the consummation of various steps taken by System Energy, which allowed it to pay cash dividends on common stock, see Note 4 –"Lines of Credit and Related Borrowings."

Also, in December 1988, System Energy completed a sale and leaseback transaction with respect to a portion of its 90% ownership interest in Grand Gulf 1, for an aggregate of $500 million. Lower cost of capital and accelerated use of tax benefits as a result of the sale and leaseback transaction will enable System Energy to charge the System operating companies lower than previously projected rates for Grand Gulf 1 capacity and energy. For further information regarding System Energy's sale and leaseback, see Note 9 –"Leases."

In another favorable development, under provisions contained in the agreement settling Arkansas Power & Light Company's (AP&L) Grand Gulf 1-related rate issues (settlement agreement) and in the order issued with respect to MP&L's Grand Gulf 1-related rate issues (final order on rehearing), these companies requested and received approvals from their state regulatory bodies to revise their rate phase-in plans relating to the recovery of Grand Gulf 1-related costs such that their plans are now in compliance with the requirements of Statement of Financial Accounting Standards (SFAS) No. 92. (See Note 2 – "Rate and Regulatory Matters.")

While the June 24 Decision and the other developments stated above represent and reflect very favorable developments, the System still faces other uncertainties, described herein, which may adversely impact its future financial condition.

On February 4, 1988, after a lengthy prudence investigation, the New Orleans City Council (council) adopted a resolution (February 4 Resolution) requiring New Orleans Public Service Inc. (NOPSI) to absorb $135 million of its previously deferred Grand Gulf 1-related costs, which was recorded as a write-off in 1987, in addition to the $51.2 million of such costs previously absorbed in connection with the March 1986 rate settlement between NOPSI and the council (rate settlement). The consequences of the February 4 Resolution, so long as it remains in effect, are that NOPSI's ability to effect long- or short-term external borrowings or to satisfy

potential obligations to purchase all or a portion of its outstanding general and refunding (G&R) bonds will continue to be significantly and adversely affected, and NOPSI could ultimately be rendered insolvent. In this connection, NOPSI has continued to retain independent special counsel experienced in bankruptcy matters to help evaluate the options available to NOPSI. (See Note 8 – "Commitments and Contingencies – NOPSI Prudence Disallowance and Other Controversies Concerning Grand Gulf 1," for more information.)

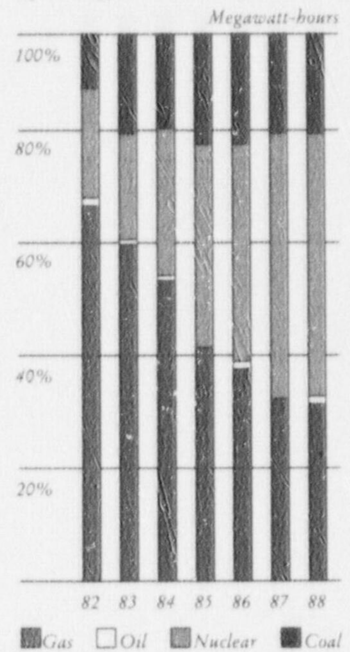
In addition, the June 13 Decision, whereby FERC allocated the capacity and energy from System Energy's share of Grand Gulf 1 and the costs associated therewith among the System operating companies, was reaffirmed by FERC in a November 30, 1987, order (November 30 Order), which has been appealed by various parties to the D.C. Circuit. Further, various state and local regulatory bodies have been considering initiating a proceeding before FERC regarding various Grand Gulf 1 prudence issues. (See Note 2 – "Rate and Regulatory Matters.")

On June 18, 1987, FERC issued an audit report pertaining to System Energy and the Grand Gulf Station. In its report, the FERC staff (staff) states, among other things, that the Grand Gulf Station's allowance for funds used during construction (AFUDC) is overstated, and that a significant portion of System Energy's unrealized recorded income tax benefits should be reclassified to accounts receivable from associated companies. System Energy has strongly disagreed with the staff's position, asserting that the staff's position is in violation of the Securities and Exchange Commission's (SEC) tax allocation regulations applicable to holding company systems and contrary to FERC's own accounting rules. If certain of the staff's findings are ultimately sustained, the resulting charges against net income and refund requirements would have a materially adverse impact on System Energy, and its prospective earnings, cash flow, and financial condition would be adversely affected. The effect on the System if the staff's findings are ultimately sustained and refunds to the System operating companies are required would depend upon the associated retail rate treatment. (See Note 8 – "Commitments and Contingencies – FERC Audit of System Energy.")

In September 1985, when construction was suspended, Unit 2 of the Grand Gulf Station (Grand Gulf 2) was approximately 34% complete based on the man-hours then estimated to be needed to complete the unit. As of December 31, 1988, System Energy had recorded approximately $905 million on its balance sheet as an investment in Grand Gulf 2. In December 1986, based on the recommendation of a special group of System officials and outside consultants, System Energy's Board of Directors (with the MSU Board of Directors concurring) decided that suspension of construction should 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. System Energy does not intend, prior to a further decision concerning the status of Grand Gulf 2, to make an application to FERC with respect to the recovery through rates of System Energy's investment in Grand Gulf 2. During 1989, System Energy will analyze the future status of Grand Gulf 2. (See Note 8 – "Commitments and Contingencies – Uncertainties Relating to Grand Gulf 2," for further information concerning Grand Gulf 2, including issues regarding recovery by System Energy of its investment in Grand Gulf 2, the adoption by FERC of its "50/50 sharing" policy regarding recovery of canceled or abandoned plant costs, and the effect on MSU of certain accounting standards should Grand Gulf 2 be abandoned.)

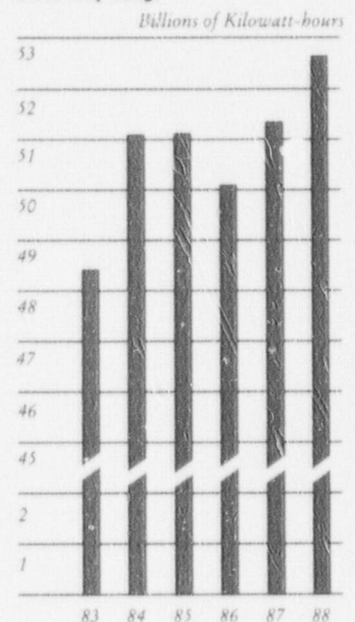
The council has been considering the acquisition by the City of New Orleans of the electric and gas utility properties of NOPSI. NOPSI believes that any attempt by the city to municipalize NOPSI's electric utility facilities in order to attempt to enable electric customers in the city to avoid paying their federally allocated share of Grand Gulf 1-related costs could result in extensive and complex proceedings before various regulatory authorities and the courts, all of which could take many years to resolve. On March 29, 1988, the council proposed

Electricity Generation by Fuel Type



NOTE: Percentages are for energy actually generated and not System capacity. Negligible amounts of hydroelectric generation are not plotted.

System Retail Customer Electricity Usage



to MSU to discuss a "friendly buyout" of NOPSI by the city. MSU responded by indicating a willingness to consider any alternatives that the council might propose if they are in the best interests of its stockholders, customers, and employees. Representatives of NOPSI and MSU are continuing to meet with members of the council and their consultants to discuss these matters. The ultimate outcome of these discussions cannot be predicted.

In December 1988, the Financial Accounting Standards Board (FASB) issued SFAS No. 100, Accounting for Income Taxes – Deferral of the Effective Date of FASB Statement No. 96, which extended the effective date of SFAS No. 96, Accounting for Income Taxes, to fiscal years beginning after December 15, 1989. Based on a preliminary study, it is expected that the adoption of SFAS No. 96 will result in a net increase in accumulated deferred income taxes with a corresponding increase in assets. MSU, the System operating companies, and System Energy's results of operations are not expected to be significantly impacted by the adoption of SFAS No. 96. (See Note 3 – "Income Taxes.")

Liquidity and Capital Resources

The capital and external financing requirements of the System, discussed herein, are based on a number of assumptions, including (1) the continued allocation of Grand Gulf 1 capacity and energy in accordance with the June 13 Decision and the November 30 Order; (2) the reversal of the February 4 Resolution in 1989, reinstatement on NOPSI's books of an asset of $135 million previously written off, and resumption of rate collection at the level provided in the rate settlement; (3) the resolution in System Energy's favor of FERC audit issues; (4) the continued suspension of construction activities at Grand Gulf 2, except for those activities necessary for demobilization and suspension of the unit; (5) no transfer of ownership of a substantial portion of NOPSI's electric and/or gas utility properties; and (6) certain other assumptions and judgments with respect to, among other things, earnings, dividends, the outcome of regulatory and judicial proceedings, financing plans, and access to capital markets. Depending upon the resolution of the above matters, material changes in capital and financing requirements could result.

The System's capital and refinancing requirements in the period 1989-91 are expected to be met primarily with internally generated funds. However, a number of uncertainties continue to confront the System, and, depending upon the ultimate resolution of such uncertainties and the effects thereof upon the System operating companies and System Energy, additional funds from external sources may be required. System Energy anticipates that its projected internally generated funds for the period 1989-91 will enable it to largely satisfy its cash requirements. AP&L, Louisiana Power & Light Company (LP&L), and MP&L will require limited amounts of external financing during the period. NOPSI will also require external financing during the period 1989-91, which it hopes to be able to obtain through a combination of means, including sales of G&R bonds, the making of short-term borrowings, and the sales of such other securities and the effecting of such other financings as may be determined appropriate under the circumstances.

Capital and external financing requirements for the System for the period 1989-91 are estimated to be as follows:

	1989	*1990*	*1991*	*Total*
		(In Millions)		
Capital Requirements:				
Construction expenditures	$393.0	$416.0	$411.5	$1,220.5
Phase-in requirements (1)	180.6	97.0	(30.0)	247.6
Nuclear fuel not financed under lease	26.1	–	–	26.1
Total capital requirements	$599.7	$513.0	$381.5	$1,494.2
Financing Requirements:				
Total capital requirements	$599.7	$513.0	$381.5	$1,494.2
Less internally generated funds and changes in cash and short-term debt	682.9	467.9	458.5	1,609.3
Net financing requirements	(83.2)	45.1	(77.0)	(115.1)
Plus refinancing requirements:				
Long-term debt maturities and sinking funds (2)	45.4	29.5	368.1	443.0
Preferred stock sinking funds	20.0	42.3	31.9	94.2
Total external financing requirements	$(17.8)	$116.9	$323.0	$ 422.1

(1) See Note 2 – "Rate and Regulatory Matters – Revised Rate Phase-In Plans" for information with respect to phase-in plans of the System operating companies.
(2) System Energy and LP&L expect to remarket $27.1 million and $220 million, respectively, of pollution control revenue bonds in 1989. To the extent such remarketing is not successful, System Energy and LP&L may be required to reacquire such bonds, resulting in additional financing requirements. NOPSI may be required to purchase up to $115 million principal amount of its outstanding G&R bonds on February 9, 1990. (See Note 2 – "Rate and Regulatory Matters – NOPSI Prudence Disallowance.") System Fuels, Inc. plans to replace a nuclear fuel financing arrangement in 1989. To the extent this arrangement is not extended or replaced, additional financing requirements of up to $65 million could result. Such amounts are not included in the above table.

However, as discussed herein, NOPSI's ability to obtain funds from external sources is severely limited at this time.

In addition, certain of the System operating companies are proceeding, subject to the receipt of necessary regulatory approval, with arrangements for the possible redemption, purchase, or other acquisition of all or a portion of certain outstanding series of high-cost debt and preferred stock. Further, System Energy and certain System operating companies may enter into arrangements for the sale and leaseback of property in which the proceeds from such transactions could be used to retire certain debt issues at par.

In general, the System operating companies and System Energy's ability to access the capital markets and to raise funds from external sources will be subject to receipt of SEC, and, in certain cases, state and local regulatory, approval and may be affected by a number of factors, including legal and regulatory developments (see Note 2 – "Rate and Regulatory Matters" and Note 8 – "Commitments and Contingencies"), the credit ratings of their securities, market conditions, and contractual and regulatory restrictions limiting the amounts of bonds and other securities that the System operating companies and System Energy may issue.

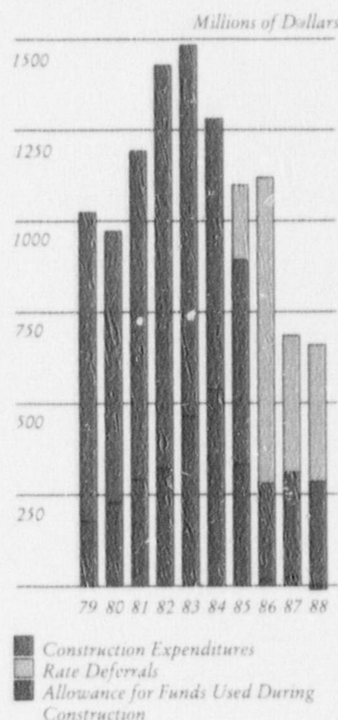
The amounts of additional mortgage bonds and preferred stock that can be issued by the System operating companies and System Energy in the future are contingent upon earnings, the amounts of unfunded bondable property and, in the case of MP&L and NOPSI, the amounts of cumulative Grand Gulf 1-related rate deferrals recorded as assets available to support the issuance of additional G&R bonds. Based on earnings coverage tests, available bondable property and, in the case of MP&L and NOPSI, cumulative Grand Gulf 1-related rate deferrals recorded as of December 31, 1988, the System operating companies and System Energy could have issued mortgage bonds or preferred stock in the following approximate amounts, at an assumed annual interest or dividend rate of 11%. In addition, AP&L, LP&L, MP&L, and System Energy had the ability at that date, subject to meeting certain conditions, to issue bonds against the retirement of bonds without meeting an earnings coverage test.

The System operating companies and System Energy are authorized through 1990 by the SEC to effect short-term borrowings in an aggregate amount outstanding at any one time of up to a specified dollar amount for each company [(in millions) AP&L – $125; LP&L – $125; MP&L – $100; NOPSI – $30; and System Energy – $125], subject to increase to a maximum of 10% of each company's respective capitalizations with further SEC approval. However, the ability of the System operating companies and System Energy to borrow is subject to the availability of funds through bank lines and other credit sources. System Energy is limited by one of its credit arrangements to short-term borrowings in an aggregate amount not exceeding 5% of capitalization (approximately $234.8 million at December 31, 1988). MP&L and NOPSI are limited by the terms of their G&R mortgages to

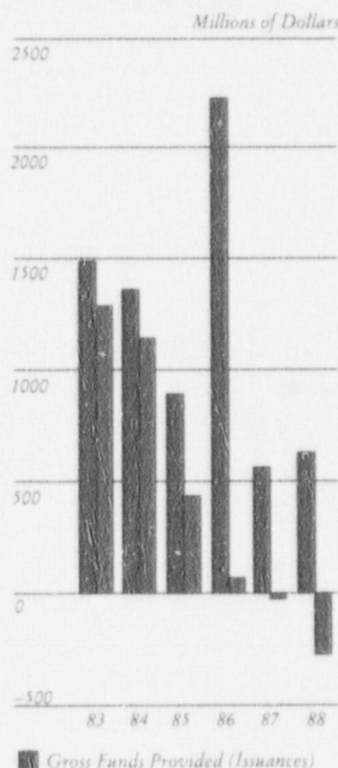
Additional Issuances Available as of Dec. 31, 1988	*Bonds*	*Preferred Stock*
	(In Thousands)	
AP&L	$308,000	$213,000
LP&L	97,000	–
MP&L	118,600	3,600
NOPSI	– (1)	7,000
System Energy	256,000(2)	– (3)

(1) Due to the council's February 4 Resolution, NOPSI was compelled to write off $135 million of accumulated deferred Grand Gulf 1-related costs previously recorded as an asset on its books. As a result, at December 31, 1988, NOPSI's cumulative deferred Grand Gulf 1-related costs aggregated $168.7 million. Since the amount of NOPSI's G&R bonds outstanding at December 31, 1988, ($115 million) exceeded 66-2/3% of NOPSI's cumulative deferred Grand Gulf 1-related costs as recorded on its books, NOPSI was precluded, under the terms of its indenture, from issuing any additional G&R bonds as of that date.
(2) The amount of bonds issuable on the basis of System Energy's unfunded bondable property is calculated based only upon Grand Gulf 1 unfunded bondable property.
(3) System Energy's Articles of Incorporation do not currently provide for the issuance of preferred stock.

Capital Requirements Related to Construction Expenditures and Rate Deferrals



External Financing Activity



NOTE: Net financings for 1988 include $487.7 million of first mortgage bonds retired by System Energy in January 1989 with proceeds from its Grand Gulf 1 sale/leaseback in December 1988.

short-term borrowings in an aggregate amount not exceeding, in general, the greater of 10% of capitalization or 50% of Grand Gulf 1-related rate deferrals available to support the issuance of G&R bonds. In addition, LP&L, MP&L, and NOPSI are subject to an SEC order that prohibits incurrence of short-term indebtedness if common stock equity is, or would thereby become, less than 30% of the sum of total capitalization plus short-term indebtedness. As a result of the $135 million write-off of previously deferred Grand Gulf 1-related costs, and the reduction of NOPSI's common stock equity caused thereby (19.3% of total capitalization as of December 31, 1988), NOPSI is currently precluded from effecting any short-term borrowings, whether through bank loans or money pool borrowings, without further SEC approval, which is not likely to be obtained under the present circumstances.

Short-term borrowings of System Energy and each System operating company up to the authorized amounts can be effected through the money pool, subject to the availability of funds that at any particular time may be limited. The money pool provides the means whereby System companies participating therein and having available funds can lend those funds to other participating companies in the System (other than MSU) having short-term borrowing needs, thereby reducing the System's dependence upon external short-term borrowings. At December 31, 1988, the funds available in the money pool for borrowing aggregated approximately $619.0 million.

			Outstanding	
	Authorized	*Available Bank Lines*	*Banks*	*Money Pool*
		(In Thousands)		
AP&L	$125,000	$43,288	$ –	$ –
LP&L	73,000	67,300	–	–
MP&L	100,000	30,000	–	22,000
NOPSI	–	–	–	–
System Energy	125,000	–	–	–

The authorized amounts (based on the most restrictive applicable limitation) of short-term borrowings, available bank lines, and the amounts outstanding at February 28, 1989, for the System operating companies and System Energy are set forth in the above table.

The Company does not have any present plans to issue additional shares of its common stock or otherwise to obtain funds from external sources through future issuances of securities or other financings.

In connection with the Grand Gulf Station, the Company has undertaken to provide or cause to be provided to System Energy sufficient capital to (1) maintain System Energy's equity capital at an amount at least equal to 35% of total capitalization (excluding short-term debt), (2) construct, own, and place in commercial operation the Grand Gulf Station, (3) provide for pre-operating expenses and interest charges of System Energy, (4) permit the continuation of commercial operation after commencement thereof, and (5) pay in full all indebtedness for borrowed money of System Energy whether at maturity, on prepayment, on acceleration, or otherwise.

Results of Operations

Discussed herein are those factors affecting results of operations for which significant changes have occurred for the year 1988 compared with 1987 and for the year 1987 compared with 1986.

The System's net income for 1988 was $411.0 million, an increase of approximately $54.4 million, or 15.3%, from 1987. This increase was primarily attributable to the write-off by NOPSI in 1987 of $135 million ($72.9 million net of tax) of disallowed Grand Gulf 1 costs that were previously deferred. Partially offsetting this factor was a reduction in System Energy's rate of return on common equity from 16% to 14%, effective July 1, 1987, applied to a lower net unit investment. The System's net income for 1987 was $356.6 million, a decrease of approximately $97.9 million, or 21.5%, from 1986. This decrease was primarily attributable to (1) the write-off by NOPSI in 1987 of $135 million ($72.9 million net of tax) of disallowed Grand Gulf 1-related costs that were previously deferred, (2) a nonrecurring accounting adjustment reported by NOPSI in 1986, and (3) the discontinuance of Waterford 3 deferrals by LP&L throughout most of 1987.

For 1988, earnings per share on MSU common stock increased to $2.01, up from $1.74 recorded in 1987, but down from the 1986 amount of $2.22. The 1988 increase and the 1987 decrease reflect the factors mentioned herein.

Fuel and fuel-related expenses for electric generation for 1987 declined $57.8 million, or 6.7%, from 1986. 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 1988 increased $45.4 million, or 47.0%, compared with 1987, whereas purchased power expenses in 1987 decreased $31.8 million, or 24.8%, compared with 1986. The 1988 increase was due primarily to increased amounts of power being purchased from outside utilities under long-term purchase contracts. The 1987 decrease was 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 purchase of power from companies outside the System.

In connection with their respective rate moderation plans, the

System operating companies deferred for future recovery through rates certain operating expenses totaling $292.1 million, $333.5 million, and $785.9 million, respectively, in 1988, 1987, and 1986. The decrease in 1988 from 1987 was due to certain of the System operating companies recovering a larger portion of their current Grand Gulf 1-related costs through increased rates, and thereby deferring a lesser amount. The decrease in 1987 from 1986 was primarily due to (1) NOPSI's write-off of $135 million in 1987 of previously deferred Grand Gulf 1-related costs, (2) LP&L's discontinuance for most of 1987, pursuant to orders of the Louisiana Public Service Commission, of additional Waterford 3 deferrals, and (3) NOPSI's one-time deferral in 1986 of $29.5 million of its Grand Gulf 1-related costs that had been expensed in 1985.

Depreciation expense increased $44.9 million, or 13.2%, in 1987 from 1986. Effective January 1, 1987, System Energy's depreciation rate was changed from the units-of-production method to a straight-line basis. The use of the straight-line method in 1987 resulted in increased depreciation expense over the prior year due primarily to the recording of additional depreciation expense in connection with the commercial operation of Grand Gulf 1 and Waterford 3.

Total income tax expense decreased $33.7 million, or 12.3%, in 1988 compared with 1987, and decreased $251.9 million, or 47.8%, in 1987 compared with 1986. The 1988 and 1987 decreases are primarily attributable to a decline in pre-tax book income and the enactment of the Tax Reform Act of 1986, which effectively reduced the maximum corporate income tax rate from 46% to 34%, effective July 1, 1987.

Miscellaneous income and deductions–net increased $28.0 million, or 32.6%, in 1988 compared with 1987, and increased $9.4 million, or 12.4%, in 1987 compared with 1986. The 1988 increase is due primarily to increased interest income earned on temporary cash investments and also due to an $8.2 million gain recorded on the sale of Associated Natural Gas Company (ANG) in June 1988. The 1987 increase is also due to increased interest income.

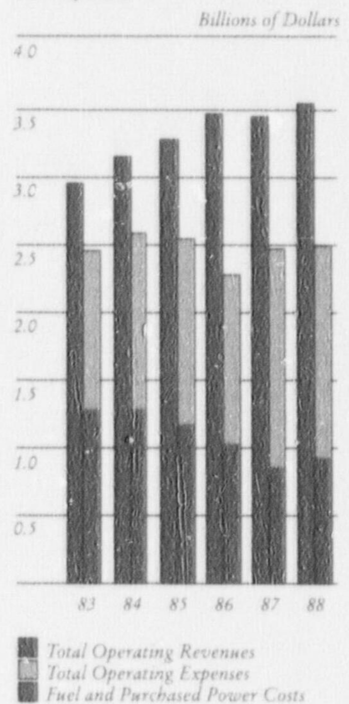
Interest on long-term debt showed a decrease of $55.8 million, or 8.1%, in 1987 compared with 1986. The 1987 decrease is primarily attributable to the early retirement or refinancing of previously outstanding high-interest rate bonds.

Other interest–net decreased $8.3 million, or 18.8%, in 1988 compared with 1987, and decreased $9.5 million, or 27.4%, in 1987 compared with 1986. The decrease in 1988 is due primarily to the retirement in January 1988 of $158.0 million of short-term notes that had been outstanding since April 1987. The 1987 decrease reflects a reduction in the amount of short-term borrowings and in interest rates on such borrowings.

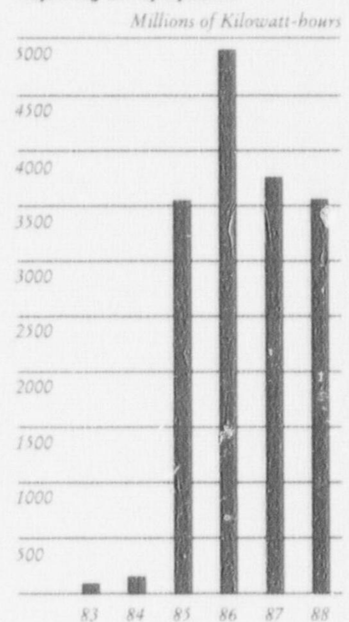
Summary

A major uncertainty facing the System was favorably resolved with the June 24 Decision of the U.S. Supreme Court. Prospects for significant improvement in the System's financial position occasioned by, among other things, the June 24 Decision have permitted the Company's Board of Directors to resume the declaration of common stock dividends. Additionally, another major uncertainty facing the System has been favorably resolved with the modifications of the rate phase-in plans of AP&L and MP&L. While the outlook for the System's future financial condition has greatly improved, a number of significant uncertainties remain. These uncertainties include (1) the outcome of continuing controversies concerning Grand Gulf 1, including a $135 million prudence disallowance with respect to NOPSI, (2) the potential adverse impact on System Energy if certain findings stemming from a FERC audit of System Energy and the Grand Gulf Station are ultimately sustained, and (3) the ultimate resolution of the status of Grand Gulf 2, construction of which has been suspended, including related accounting and rate issues. In addition, NOPSI's financial position could be affected by the outcome of the council's consideration of municipalization of NOPSI's electric and gas utility properties.

Operating Revenues and Expenses



Wholesale Electricity Sales to Adjoining Utility Systems



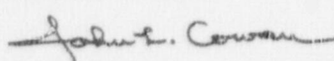
Report of Management

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 that 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, a recently issued employee Code of Conduct, 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 independent public accountant provides 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.



Edwin Lupberger
Chairman and President

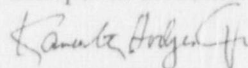
John L. Cowan
System Executive — Finance

Audit Committee Chairman's Letter

The MSU Board of Directors' Audit Committee comprises five directors, who are not officers of the Company: Kaneaster Hodges Jr. (Chairman), W. Frank Blount, James B. Campbell, James R. Nichols, and Dr. Walter Washington. The committee held four meetings during 1988.

The Audit Committee oversees the Company's financial reporting process on behalf of the MSU Board of Directors. In fulfilling its responsibility, the committee recommended to the board, subject to stockholder approval, the selection of the Company's independent public accountant (Deloitte Haskins & Sells). Also, the committee oversees and coordinates the activities and policies of the subsidiary companies' audit committees.

The Audit Committee discussed with the internal auditor and the independent public accountant the overall scope and specific plans for their respective audits, as well as the Company's consolidated financial statements and the adequacy of the Company's internal controls. The committee met separately with the Company's internal auditor and independent public accountant, without management present, to discuss the results of its examinations, its evaluations of the Company's internal controls, and the overall quality of the Company's financial reporting. The meetings were designed to facilitate and encourage any private communication between the committee and the internal auditor or independent public accountant.



Kaneaster Hodges Jr., Chairman
Audit Committee

Independent Auditors' Report

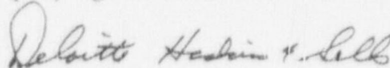
The Stockholders and the Board of Directors of Middle South Utilities, Inc.:

We have audited the consolidated balance sheets of Middle South Utilities, Inc. as of December 31, 1988 and 1987, and the related statements of consolidated income, of retained earnings and paid-in capital, and of cash flows for each of the three years in the period ended December 31, 1988. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the above-mentioned consolidated financial statements present fairly, in all material respects, the financial position of the Company and its subsidiaries at December 31, 1988 and 1987, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1988, in conformity with generally accepted accounting principles.

As discussed in Notes 2 and 8 of the Notes to Consolidated Financial Statements, there are several uncertainties facing the Company and its subsidiaries. These uncertainties involve the recoverability of a suspended construction project, the potential adverse impact stemming from a regulatory audit if certain findings are ultimately sustained, and the potential obligation of one of the System operating companies to purchase a portion of its outstanding bonds which, if required, could render that company insolvent as there is no assurance that it would have sufficient available cash resources or financing capabilities to meet this obligation. The ultimate outcome of these uncertainties cannot presently be determined. Accordingly, no provision for any loss that may result upon resolution of these matters has been made in the accompanying consolidated financial statements.



New Orleans, Louisiana

March 3, 1989

STATEMENTS OF CONSOLIDATED INCOME

Middle South Utilities, Inc. and Subsidiaries

For the Years Ended December 31,	1988	1987	1986
		(In Thousands)	
Operating Revenues:			
Electric	$ 3,473,552	$3,327,117	$3,339,132
Natural gas	91,853	127,703	146,780
Total	3,565,405	3,454,820	3,485,912
Operating Expenses:			
Operation:			
Fuel for electric generation and fuel-related expenses	778,138	801,594	859,350
Purchased power	141,992	96,595	128,405
Gas purchased for resale	62,661	83,800	104,036
Other	751,274	686,460	722,664
Maintenance	235,733	256,202	242,261
Depreciation	390,554	384,374	339,438
Taxes other than income taxes	172,135	169,696	161,042
Income taxes (Note 3)	152,638	161,817	166,036
Rate deferrals:			
Rate deferrals (Notes 1 and 2)	(292,078)	(468,495)	(785,897)
Write-off of previously deferred Grand Gulf 1 expenses (Notes 2 and 8)	–	135,000	–
Income taxes (Note 3)	102,789	137,721	383,180
Total	2,495,836	2,444,764	2,320,515
Operating Income	1,069,569	1,010,056	1,165,397
Other Income:			
Allowance for equity funds used during construction	7,818	7,901	8,830
Miscellaneous income and deductions – net	113,845	85,849	76,403
Income taxes – credit (Note 3)	14,549	24,918	22,656
Total	136,212	118,668	107,889
Interest and Other Charges:			
Interest on long-term debt	663,477	637,139	692,980
Other interest – net	35,826	44,095	34,608
Allowance for borrowed funds used during construction	8,680	(1,092)	590
Preferred dividend requirements of subsidiaries	86,770	91,978	90,643
Total	794,753	772,120	818,821
Net Income	$ 411,028	$ 356,604	$ 454,465
Earnings per Common Share	$2.01	$1.74	$2.22
Dividends Declared per Common Share (Note 7)	$0.20	–	–
Number of Common Shares Outstanding	204,581,092	204,581,092	204,581,092

See Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

Middle South Utilities, Inc. and Subsidiaries

December 31,	1988	1987
	(In Thousands)	
Assets		
Utility Plant (Notes 1 and 9):		
Electric	$13,222,773	$12,855,563
Property under capital lease – electric	120,766	120,018
Natural gas	94,942	135,174
Property under capital lease – gas	1,001	815
Construction work in progress	170,265	263,465
Nuclear fuel	95,456	182,557
Nuclear fuel under capital lease	396,052	397,867
Total	14,101,255	13,955,459
Less – Accumulated depreciation and amortization	2,989,863	2,715,314
Utility plant – net	11,111,392	11,240,145
Other Property and Investments:		
Letter of credit escrow (Note 4)	–	108,562
Other	86,207	103,635
Total	86,207	212,197
Current Assets:		
Cash	15,389	19,996
Temporary investments – at cost, which approximates market (Notes 2 and 9)	1,366,555	579,899
Total cash and cash equivalents (Note 1)	1,381,944	599,895
Funds held by first mortgage bond trustee	–	60,000
Bonding trust arrangement (Note 2)	–	101,202
Special deposits	13,510	15,477
Notes receivable	2,916	1,170
Accounts receivable:		
Customer [less allowance for doubtful accounts of (in thousands) $7,596 in 1988 and $7,574 in 1987]	147,509	136,807
Other	34,483	20,407
Accrued unbilled revenues (Note 1)	54,726	50,9[illegible]
State income taxes receivable	2,859	8,778
Accumulated deferred income taxes (Note 3)	38,598	–
Fuel inventory (Notes 1 and 4)	64,739	95,312
Materials and supplies – at average cost	179,534	110,323
Rate deferrals (Notes 1 and 2)	91,229	11,765
Prepayments and other	64,538	55,910
Total	2,076,585	1,267,982
Deferred Debits:		
Rate deferrals (Notes 1 and 2)	1,559,724	1,346,090
Suspended construction project (Note 8)	904,984	889,780
Other	202,924	200,638
Total	2,667,632	2,436,508
Total	$15,941,816	$15,156,832

See Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

Middle South Utilities, Inc. and Subsidiaries

December 31,	1988	1987
	(In Thousands)	
Capitalization and Liabilities		
Capitalization:		
Common stock, $5 par value, authorized 500,000,000 shares; issued and outstanding 204,581,092 shares	$ 1,022,905	$ 1,022,905
Paid-in capital	1,567,781	1,565,466
Retained earnings (Note 7)	2,310,242	1,939,757
Total common stockholders' equity	4,900,928	4,528,128
Subsidiaries' preferred stock (Note 5):		
Without sinking fund	330,967	330,967
With sinking fund	462,965	496,405
Long-term debt (Notes 6, 8, and 9)	6,187,442	5,945,054
Total	11,882,302	11,300,554
Noncurrent Liabilities:		
Obligations under capital leases (Note 9)	260,858	245,477
Other	56,876	50,581
Total	317,734	296,058
Current Liabilities:		
Notes payable (Note 4):		
Commercial paper	26,000	65,000
Other	21,657	190,667
Currently maturing long-term debt (Note 6)	306,346	336,382
Accounts payable	286,989	271,293
Gas contract settlements – liability to customers (Notes 2 and 11)	257,054	60,765
Deferred fuel cost	9,535	32,458
Customer deposits	73,880	67,904
Taxes accrued	162,485	76,142
Accumulated deferred income taxes (Note 3)	-	9,773
Interest accrued	165,723	168,896
Preferred dividends declared	23,454	22,192
Obligations under capital leases (Note 9)	300,118	318,460
Other	52,209	84,279
Total	1,685,450	1,704,211
Deferred Credits:		
Accumulated deferred income taxes (Note 3)	1,597,921	1,327,932
Accumulated deferred investment tax credits (Note 3)	66,621	55,332
Gas contract settlements – liability to customers (Note 11)	225,329	281,612
Other	166,459	191,133
Total	2,056,330	1,856,009
Commitments and Contingencies (Note 8)		
Total	$15,941,816	$15,156,832

See Notes to Consolidated Financial Statements.

STATEMENTS OF CONSOLIDATED CASH FLOWS

Middle South Utilities, Inc. and Subsidiaries

For the Years Ended December 31,	1988	1987	1986
		(In Thousands)	
Operating Activities:			
Net income	$ 411,028	$ 356,604	$ 454,465
Non-cash items included in net income:			
Rate deferrals (Notes 1 and 2)	(292,078)	(468,495)	(785,897)
Write-off of previously deferred Grand Gulf 1 expenses (Notes 2 and 8)	–	135,000	–
Depreciation	390,554	384,374	339,438
Deferred income taxes and investment tax credits	209,219	264,187	559,983
Allowance for equity funds used during construction	(7,818)	(7,901)	(8,830)
Write-off of deferred costs relating to standard coal plant design and equipment	–	–	31,657
Write-off of deferred costs relating to SFI's fuel acquisition program	–	–	19,151
Provisions for estimated losses	(693)	5,025	19,842
Net gain on the sale of ANG	(5,350)	–	–
Changes in working capital:			
Receivables	(37,657)	59,887	13,824
Fuel inventory	30,573	(1,946)	26,177
Accounts payable	15,696	(8,898)	(82,307)
Other working capital accounts	(43,687)	(11,898)	(54,373)
Proceeds from gas contract settlements (Notes 2 and 11)	196,835	20,091	12,219
Refunds to customers – gas contract settlements (Note 11)	(57,152)	(252,785)	(56,374)
Change in bonding trust arrangement (Note 2)	101,202	(101,202)	–
Increase in decommissioning trust	(26,705)	(2,744)	–
Other	20,195	25,491	(43,784)
Net cash flow provided by operating activities	904,162	394,790	445,191
Investing Activities:			
Construction expenditures	(338,091)	(351,227)	(335,289)
Allowance for equity funds used during construction	7,818	7,901	8,830
Nuclear fuel sales to lessors	–	58,607	109,579
Nuclear fuel expenditures	(40,123)	(65,800)	(74,718)
Expenditures on suspended construction project (Note 8)	(12,194)	(10,403)	–
Proceeds received from the sale of ANG	27,095	–	–
Other property – net	1,724	–	–
Net cash flow used by investing activities	(353,771)	(360,922)	(291,598)
Financing Activities:			
Proceeds from issuance of:			
Preferred stock	–	35,000	85,000
First mortgage bonds	75,000	375,000	1,750,000
General and refunding mortgage bonds	115,000	75,000	–
Bank notes and other long-term debt (Note 9)	504,628	51,377	427,846
Retirement of first mortgage bonds	(106,603)	(107,365)	(860,548)
Retirement of bank notes and other long-term debt	(381,250)	(406,758)	(1,352,912)
Redemption of preferred stock	(30,420)	(48,030)	(40,961)
Sale and leaseback of nuclear fuel	129,827	66,446	34,419
Common stock dividends paid	(40,916)	–	–
Proceeds from letter of credit escrow (Note 4)	192,885	–	–
Letter of credit escrow payments (Note 4)	(84,323)	(89,400)	(19,162)
Funds released by first mortgage bond trustee	60,000	(60,000)	–
Changes in short-term borrowings	(208,010)	119,667	(162,295)
Proceeds from sale of spare parts inventory	5,741	–	–
Other	99	–	–
Net cash flow provided (used) by financing activities	231,658	10,937	(138,613)
Net increase in cash and cash equivalents	782,049	44,805	14,980
Cash and cash equivalents at beginning of period	599,895	555,090	540,110
Cash and cash equivalents at end of period	$1,381,944	$ 599,895	$ 555,090
Supplemental Disclosures of Cash Flow Information:			
Cash paid (received) during the period for:			
Interest	$ 767,311	$ 745,608	$ 767,491
Income taxes (net of refunds)	$ 4,418	$ (4,815)	$ 2,479
Supplemental Schedule of Non-Cash Investing and Financing Activities:			
Capital lease obligations incurred	$ 129,629	$ 71,088	$ 67,607
First mortgage bonds assumed by third party in the sale of ANG	$ (3,780)	–	–
Preferred stock dividend requirements of subsidiaries	$ 86,770	$ 91,978	$ 90,643

See Notes to Consolidated Financial Statements.

STATEMENTS OF CONSOLIDATED RETAINED EARNINGS AND PAID-IN CAPITAL

Middle South Utilities, Inc. and Subsidiaries

For the Years Ended December 31,	1988	1987	1986
		(In Thousands)	
Retained Earnings, January 1	**$1,939,757**	$1,583,402	$1,130,995
Add – Net income	**411,028**	356,604	454,465
Total	**2,350,785**	1,940,006	1,585,460
Deduct:			
Dividends declared on common stock – (Note 7)	**40,916**	–	–
Capital stock and other expenses	**(373)**	249	2,058
Total	**40,543**	249	2,058
Retained Earnings, December 31 (Note 7)	**$2,310,242**	$1,939,757	$1,583,402
Paid-in Capital, January 1	**$1,565,466**	$1,565,889	$1,567,866
Add:			
Gain (loss) on the reacquisition of preferred stock and other	**2,315**	(423)	(1,977)
Paid-in Capital, December 31	**$1,567,781**	$1,565,466	$1,565,889

See Notes to Consolidated Financial Statements.

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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), System Energy Resources, Inc. (System Energy), System Fuels, Inc. (SFI), and Electec, Inc. The above companies, excluding Electec, Inc., are collectively referred to as the Middle South Electric System or System. All significant intercompany transactions have been eliminated except as allowed by Statement of Financial Accounting Standards (SFAS) No. 71.

On June 1, 1988, AP&L, as required by the Securities and Exchange Commission (SEC), disposed of its interest in Associated Natural Gas Company (ANG) by means of a cash merger of ANG with and into Arkansas Western Gas Company, a subsidiary of Southwestern Energy Company. Financial data shown for 1987 and 1986 has not been restated for the disposition of ANG since the effect of consolidation is immaterial.

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, as administered by the SEC.

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 Federal Energy Regulatory Commission (FERC). The accounts of the generating subsidiary, System Energy, are maintained in accordance with the system of accounts prescribed by FERC. The accounts of the non-utility subsidiary, Electec, Inc., are maintained in accordance with the system of accounts prescribed by the SEC.

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. LP&L accrues revenue for the non-fuel portion of estimated unbilled revenues. Unbilled revenues result from energy delivered since the period covered by the latest billings to customers. Substantially all of the operating subsidiaries' rate schedules 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.

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 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 maintenance and refueling period.

Utility Plant and Depreciation

Utility plant is stated at original cost. Partial disallowances of plant costs, as ordered by the Louisiana Public Service Commission (LPSC), have been removed from utility plant. 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 costs of units of property retired are removed from utility plant and such costs, plus removal costs, less salvage, are charged to accumulated depreciation. Maintenance and repairs of property and 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 12 months of commercial operation (which began July 1, 1985) and, with FERC's approval, for an additional six months thereafter. Subsequent to December 31, 1986, depreciation on Grand Gulf 1 is being computed on a straight-line basis at an annual rate of 2.85%. Depreciation provisions on average depreciable property approximated 3.0%, 3.0%, and 2.7% in 1988, 1987, and 1986, respectively. Substantially all of the System's utility plant is subject to the liens of the subsidiaries' mortgage bond indentures.

Rate Deferrals

The System operating companies have in effect various rate moderation or rate phase-in plans in order to reduce the immediate effect on ratepayers of the inclusion of Grand Gulf 1 and Unit 3 of the Waterford Steam Electric Generating Station (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 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 amounts 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 associated with these deferrals. In most cases, the carrying charges associated with the unamortized deferrals are recovered currently from customers. (See Note 2 – "Rate and Regulatory Matters.")

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 is to fund pension costs in accordance with contribution guidelines established by the Employee Retirement Income Security Act of 1974, as amended, and to fund and record other postretirement plan costs on a cash basis.

Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return. Pursuant to an intra-System income tax allocation agreement, income taxes are allocated to the System companies in proportion to their contribution to the consolidated taxable income. In accordance with SEC regulations, no System company is required to pay more income taxes than would have been paid had a separate income tax return been filed. 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.

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 income statement credits 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 utility service rates. Effective composite rates of the System operating companies for AFUDC were 9.6%, 9.0%, and 9.2% for 1988, 1987, and 1986, respectively.

On September 18, 1985, the Mississippi Public Service Commission (MPSC) ordered System Energy and MP&L to suspend construction of Unit 2 of the Grand Gulf Station (Grand Gulf 2) as of that date. Concurrent with the suspension of construction, System Energy ceased accruing AFUDC on the unit effective September 18, 1985. (See Note 8 – "Commitments and Contingencies – Uncertainties Relating to Grand Gulf 2.")

Other Noncurrent Liabilities

It is the policy of AP&L, LP&L, and NOPSI to record provisions for uninsured property risks, certain employee benefits, and 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.

Fuel Inventories

Effective June 1, 1988, SFI changed its method of accounting for fuel oil inventory to an average cost method from the last-in-first-out method. This change had no significant effect on net income. All System companies' fuel inventories are valued at average cost.

Statement of Cash Flows

For purposes of this statement, the Company considers all unrestricted highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

Reclassifications

Certain reclassifications of previously reported amounts have been made to conform with current classifications. These reclassifications had no effect on net income.

NOTE 2. RATE AND REGULATORY MATTERS

U.S. Supreme Court Decision

On June 24, 1988, the principle of federal preemption, which is necessary to secure implementation of System Energy's federally mandated wholesale rates through the retail rate structures of the System operating companies, was upheld by the U.S. Supreme Court (June 24 Decision). In the June 24 Decision, the Court reversed the February 25, 1987, decision of the Mississippi Supreme Court which had held, among other things, that the MPSC had improperly granted MP&L retail rate relief to pay for its Grand Gulf 1-related costs without first determining that such costs were prudently incurred. The Court held that states may not alter FERC-ordered allocations of wholesale power by substituting their own determination of what would be just and fair, and that the MPSC must therefore recognize MP&L's Grand Gulf 1-related costs as reasonable operating expenses. The Court stated that "FERC-mandated allocations of power are binding on the states, and states must treat those allocations as fair and reasonable when determining retail rates." The Court also held that the MPSC lacks jurisdiction to reevaluate the reasonableness of the various agreements among MP&L, System Energy, and MSU relating to Grand Gulf 1. Furthermore, the Court stated that "the MPSC cannot evaluate either the prudence of MSU's decision to invest in Grand Gulf and bring it on-line or the prudence of MP&L's decision to be a party to agreements to construct and operate Grand Gulf without traversing matters squarely within FERC's jurisdiction." After issuance of the Court's mandate in August 1988, funds, which had been placed in trust by System Energy pursuant to a bonding arrangement to secure any potential refund obligations of MP&L in connection with this case, were released and returned to System Energy.

Following receipt by the Mississippi Supreme Court of the U.S. Supreme Court's mandate, on October 20, 1988, the Mississippi Attorney General filed its brief with the Mississippi Supreme Court requesting that court to remand the matter to the MPSC to determine whether savings could be realized in other areas to offset MP&L's Grand Gulf 1-related costs. MP&L opposed the remand in its reply to the attorney general's brief, which was filed November 3, 1988. In the event that the Mississippi Supreme Court remands the matter to the MPSC, MP&L believes that any subsequent review by the MPSC would not justify a decrease in MP&L's retail rates.

Pursuant to the phase-in provisions of the retail rate agreements and orders under which AP&L, MP&L, and NOPSI recover costs related to Grand Gulf 1, periodic rate schedule filings must be made with regulatory authorities to implement rate increases associated with the step-up provisions of the phase-in plans. The June 24 Decision, as discussed herein, affirmed the principle that state and local regulatory authorities must recognize Grand Gulf 1-related costs as reasonable operating expenses in setting the retail rates of the System operating companies. Because AP&L, MP&L, and NOPSI are entitled to collect such costs under their respective phase-in plans, regulatory bodies or other parties could attempt to change existing non-Grand Gulf 1-related rate structures in the future in an effort to moderate overall higher retail rates as the step-up provisions of these retail rates become effective.

NOPSI Prudence Disallowance

On February 4, 1988, after a lengthy prudence investigation, the New Orleans City Council (council) adopted a resolution (February 4 Resolution) that required NOPSI to write off, and not recover from its retail electric customers, $135 million of its previously deferred Grand Gulf 1-related costs in addition to the $51.2 million of such costs that NOPSI absorbed as part of its March 1986 rate settlement between NOPSI and the council (rate settlement).

NOPSI is seeking relief in federal and state courts from this action by the council. In this connection, the U.S. Supreme Court has agreed to review the question of whether the federal courts have discretion to abstain from taking jurisdiction over NOPSI's petition seeking reversal of this disallowance based upon principles of federal preemption. NOPSI believes that the February 4 Resolution is in violation of the Federal Power Act, FERC orders with respect to the allocation of Grand Gulf 1, and federal law as interpreted by the Court (including, most recently, in the June 24 Decision), and will

ultimately be so declared by the courts. For further information regarding these issues and the potential financial implications to NOPSI, see Note 8 – "Commitments and Contingencies – NOPSI Prudence Disallowance and Other Controversies Concerning Grand Gulf 1."

Revised Rate Phase-In Plans

In August 1987, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 92, Regulated Enterprises – Accounting for Phase-in Plans, an amendment of SFAS No. 71, which requires, subject to certain transition provisions, that amounts deferred under phase-in plans that do not meet the requirements of SFAS No. 92 be written off. The retail rate phase-in plans of AP&L and MP&L, embodied in the agreement settling AP&L's Grand Gulf 1-related rate issues (settlement agreement) and in the order issued with respect to MP&L's Grand Gulf 1-related rate issues (final order on rehearing) and providing for the deferred recovery by these companies of their Grand Gulf 1-related costs, although in compliance with generally accepted accounting principles at the time of adoption, did not meet the criteria of SFAS No. 92. However, in September and October 1988, MP&L and AP&L, respectively, received approvals from their state regulatory bodies to revise their rate phase-in plans, in the manner described herein, such that they are now in compliance with SFAS No. 92. Accordingly, no write-off of costs previously deferred by MP&L and AP&L has been required as a result of SFAS No. 92.

AP&L's revised settlement agreement provides, as did the original settlement agreement, that AP&L permanently retain and not recover, except through other sales, a portion of its Arkansas retail Grand Gulf 1-related costs (retained share). The retained share (stated as a percentage of System Energy's share of Grand Gulf 1) ranges from 5.67% in 1989 to 7.92% in 1994 and all succeeding years of the unit's commercial operation.

Under the terms of the revised settlement agreement, AP&L is permitted to recover on a current basis a portion of its Arkansas retail Grand Gulf 1-related costs (current recovery share). Prior to January 1, 1989, the settlement agreement had provided that a portion of the current recovery share would be phased in, with AP&L deferring for future recovery certain costs in the first three years. Under the revised settlement agreement, these previously deferred amounts are now included in the deferred balance described herein, and there is no further deferral of any part of the current recovery share. The current recovery share (stated as a percentage of System Energy's share of Grand Gulf 1) ranges from 17.86% in 1989 to 28.08% in 1994 and thereafter.

Under the provisions of the settlement agreement, through December 31, 1988, AP&L had deferred approximately $578 million of its Arkansas retail Grand Gulf 1-related costs (Arkansas costs) for future recovery, through both the phasing-in of part of the current recovery share, as described herein, and the inventorying of an additional portion of Arkansas costs. Under the revised settlement agreement, an additional 12.47% and 6.95% of such costs (stated as a percentage of System Energy's share of Grand Gulf 1) will be deferred in 1989 and 1990, respectively, for future collection (deferral share). The deferral share, plus the $578 million of previously deferred costs (collectively, deferred balance) will be recovered by AP&L in increasing percentages from 1991 through 1998, at which time the deferred balance will have been fully collected. AP&L is permitted to recover on a current basis the incremental cost of financing the unrecovered portion of the deferred balance.

MP&L's revised plan provides, among other things, for the recovery by MP&L, in equal annual installments over the 10-year period beginning October 1, 1988, of all Grand Gulf 1-related costs deferred through September 30, 1988, pursuant to the final order on rehearing. These deferred amounts totaled approximately $648 million. Additionally, the revised plan provides that MP&L will defer decreasing amounts of its Grand Gulf 1-related costs over the four annual periods commencing October 1, 1988, with the total deferrals estimated to approximate $152 million, $114 million, $70 million, and $33 million for each annual period. These deferrals will then be recovered by MP&L over the succeeding six-year period ending September 30, 1998, in accordance with the annual recovery schedule specified in the revised plan. The revised plan further allows for the recovery by MP&L of carrying charges on all deferred amounts on a current basis.

FERC's June 13 Decision

FERC's June 13 Decision allocating the capacity and energy from System Energy's share of Grand Gulf 1 among the System operating companies (June 13 Decision) was appealed by various parties to the U.S. Court of Appeals for the District of Columbia Circuit (court of appeals). On January 6, 1987, the court of appeals affirmed the June 13 Decision, holding, among other things, that FERC had authority to review and modify the allocation of power from Grand Gulf 1 and to establish an allocation of such power that FERC found to be just and reasonable under the Federal Power Act. Various parties filed petitions for certiorari with the U.S. Supreme Court (which were denied on December 14, 1987, thereby leaving in place that part of the court of appeals' decision upholding FERC's jurisdiction to allocate Grand Gulf 1 costs) and requests for rehearing with the court of appeals. After granting rehearing of two issues raised in the January 6, 1987, decision, the court of appeals on June 24, 1987, reversed, in part, the June 13 Decision and remanded the June 13 Decision to FERC (the June 24 Remand) for reconsideration of its decision to equalize the capacity and costs of all System nuclear plants and for an explanation of the criteria used to determine what constitutes "undue discrimination" under the Federal Power Act and why the June 13 Decision is not unduly discriminatory. In reversing,

in part, the June 13 Decision, the court of appeals did not change that part of its January 6, 1987, decision upholding FERC's authority to review and modify the allocation of power from Grand Gulf 1.

On November 30, 1987, FERC issued an order in response to the June 24 Remand whereby FERC reaffirmed and reinstated the June 13 Decision, thus maintaining the previous allocation of Grand Gulf 1 capacity and energy among the System operating companies (November 30 Order). In issuing the November 30 Order, FERC found that the allocation in the June 13 Decision was not unduly discriminatory. Various parties filed requests for rehearing of FERC's November 30 Order and, by order dated January 29, 1988, FERC denied these requests. Petitions for review of FERC's November 30, 1987, and January 29, 1988, orders have been filed with the court of appeals by various parties. In this connection, the Arkansas Public Service Commission (APSC) and other Arkansas and Missouri parties are attempting to again raise the issue of FERC jurisdiction to allocate capacity and energy and related costs to AP&L. A motion for summary affirmance as to its jurisdiction was filed by FERC. The court of appeals ordered that the jurisdictional issue be referred to the panel of judges that will decide this appeal on the merits, and that the parties are not to further brief the jurisdictional issue. Oral argument is scheduled for May 8, 1989.

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

Grand Gulf 1 Prudence

As noted, the U.S. Supreme Court's June 24 Decision affirmed the principle that various matters regarding the prudence of Grand Gulf 1 are within FERC's exclusive jurisdiction. In this connection, representatives of certain governmental bodies, including the Arkansas Attorney General, the LPSC, the MPSC, the Mississippi Attorney General, and the council, have publicly stated that they are considering whether to retain a consulting firm to develop information regarding the construction and operation of Grand Gulf 1 that may be used to approach FERC with a request to open a prudence proceeding. The System cannot predict whether any consulting firm will be retained for this purpose, whether any proceeding before FERC regarding Grand Gulf 1 prudence issues will be initiated, or in what context any prudence issues might arise. However, the System would vigorously defend against any possible allegations of imprudence with respect to Grand Gulf 1 that might be made before FERC and believes that its investment in Grand Gulf 1 was prudently incurred. In the event that a portion of System Energy's investment in Grand Gulf 1 was ultimately disallowed for ratemaking purposes, System Energy's earnings, cash flow, and financial condition would be adversely affected.

NOPSI Municipalization

The council, in connection with controversies surrounding the allocation of capacity and energy costs of the Grand Gulf Station, has been considering the municipalization by the City of New Orleans of the electric and gas utility properties of NOPSI and the electric utility properties of LP&L in the 15th Ward of the city. (See Note 8 – "Commitments and Contingencies – NOPSI Municipalization.")

NOPSI Management Audit

In the interest of increased economic efficiency, LP&L and NOPSI have functionally consolidated their company management and personnel in a number of areas. On May 19, 1988, the council adopted a resolution calling for a "management audit and evaluation of NOPSI," expressing the council's concern "with the degree and status of the so-called functional consolidation of NOPSI with LP&L that has reportedly occurred to date, notwithstanding the lack of appropriate regulatory approvals for formal consolidation, including that required by the council," and initiating "an investigation into the management and operations of NOPSI." On June 14, 1988, NOPSI received a letter from a national accounting firm, which set out the auditing procedures that the accounting firm, a local accounting firm, and a national engineering firm plan to follow, along with an initial request for documents. The audit has continued with additional data requests and employee interviews and is nearly completed. The matter is pending.

LPSC Rate Order

LP&L filed a retail rate application with the LPSC on February 19, 1988, and updated the filing in July 1988, requesting an increase in annual base rates with respect to LPSC jurisdictional customers of $107.4 million over and above rates then in effect. Subsequently, consultants for the LPSC recommended adjustments that, if adopted, would produce a $45.9 million annual rate increase.

In a related development, a judgment was obtained in a suit between LP&L and a gas supplier in longstanding litigation stemming from, among other things, the gas supplier's failure to deliver contracted-for quantities of natural gas for power plant use during the period 1971-81, and on October 24, 1988, LP&L received from the gas supplier $193.7 million as judgment proceeds. The LPSC has asserted jurisdiction over approximately 97.4% of these proceeds in terms of the treatment thereof for the benefit of LPSC jurisdictional ratepayers.

On March 1, 1989, the LPSC issued an order that addressed both LP&L's February 1988 retail rate application and the distribution of the gas supplier judgment proceeds. The LPSC found in its order that

LP&L was entitled to an annual increase in retail rates of approximately $45.9 million, based upon a return on equity of 12.76% and an overall rate of return of 11.07%.

The March 1989 order ruled, however, that in lieu of a rate increase, LP&L retain the LPSC jurisdictional portion of the $193.7 million judgment proceeds (stated to approximate $188.6 million) and flow back to ratepayers, beginning immediately, through a rate amortization schedule that currently extends over a 5.3-year period, such jurisdictional proceeds plus accrued interest thereon through February 28, 1989. This amortization schedule provides for a reduction in LP&L's rate base by the amount of the unamortized balance of such proceeds through completion of the amortization. LP&L believes that the March 1989 order should have the effect of providing approximately the same amount of additional net income available for common stock as would an increase in LP&L's revenues of $45.7 million annually (approximating the amount of LP&L's revenue deficiency as determined by the LPSC) over the next 5.3 years, without requiring any increase in LP&L's retail rates collected from LPSC jurisdictional customers. In this connection, LP&L agreed to a five-year base rate freeze at the current level, subject to certain conditions. The conditions include, among others, a provision that would allow LP&L to apply for rate relief during the five-year period to reflect a change in the federal tax law or any net increase in its costs associated with Grand Gulf 1 resulting from proceedings commenced at FERC by the LPSC. In addition, LP&L could request a waiver of the five-year freeze if a catastrophic event caused dramatic changes in costs. Further, the five-year freeze would not serve as a bar to flowing through to retail ratepayers any net decrease in LP&L's costs resulting from proceedings at FERC relating to the Grand Gulf Station or any decrease related to changes in the federal tax law.

While the LPSC's March 1, 1989, order purported to address virtually all the issues presented in LP&L's rate application, the LPSC determined that several issues warranted further investigation. Specifically, the LPSC established subdockets in the proceeding to consider, among other issues, the propriety of the use by LP&L of an automatic adjustment clause for recovery of its Grand Gulf 1-related costs and the level and appropriateness of the Grand Gulf 1-related costs being charged by System Energy to LP&L.

The LPSC's March 1, 1989, order is subject to requests for rehearing and to appeal. One of the intervenors in these proceedings has indicated that it intends to appeal the order, and has filed a motion with the LPSC asking, among other things, that the LPSC prohibit LP&L from using and expending the LPSC jurisdictional portion of the judgment proceeds pending further order of the LPSC or a court. At this time, LP&L has not determined whether it will appeal the order, but intends to vigorously defend against such intervenor's motion and any appeal adverse to LP&L.

NOTE 3. INCOME TAXES

The tax effect of the consolidated 1986 net operating loss has been recorded as a reduction of deferred income taxes. The remaining net operating loss carryforward at December 31, 1988, amounted to $24.7 million and is available to offset federal regular taxable income in future years. If not used, it will expire in the year 2001. Unused investment tax credits at December 31, 1988, amounted to $421.2 million after the 35% reduction required by the Tax Reform Act of 1986. These credits may be applied against federal income tax liabilities in future years. If not used, they will expire in 1992 through 2003.

The alternative minimum tax (AMT) credit at December 31, 1988, was $54.5 million. This AMT credit can be carried forward indefinitely and will reduce federal regular income tax in the future.

Cumulative income tax timing differences for which deferred income tax expenses have not been provided are $443.4 million, $430.6 million, and $431.6 million in 1988, 1987, and 1986, respectively.

In December 1987, FASB issued SFAS No. 96, Accounting for Income Taxes, which was effective for years beginning after December 15, 1988. In December 1988, FASB issued SFAS No. 100, Accounting for Income Taxes – Deferral of the Effective Date of FASB Statement No. 96, which extended the effective date of SFAS No. 96 to fiscal years beginning after December 15, 1989. SFAS No. 96 expands the requirement to record deferred income taxes for all temporary differences that are reported in one year for financial reporting purposes and a different year for tax purposes. This will require the recognition of deferred tax balances for certain items not previously reflected in the financial statements, such as a deferred tax liability relating to AFUDC. Under the liability method adopted by SFAS No. 96, deferred tax balances will be based on enacted tax laws at tax rates that are expected to be in effect when the temporary differences reverse.

It is expected that reductions in deferred taxes resulting from the lower corporate federal tax rates will be reflected as liabilities to customers since the System companies' regulators may require any such savings to be passed on to the ratepayers. However, based on a preliminary study, MSU, the System operating companies, and System Energy expect that the adoption of SFAS No. 96 will result in a net increase in accumulated deferred income taxes with a corresponding increase in assets. Results of operations for MSU, the System operating companies, and System Energy are not expected to be significantly impacted by the adoption of SFAS No. 96.

Income tax expense (credit) consists of the following:

	1988	1987	1986
		(In Thousands)	
Current:			
Federal	$ 17,144	$ 10,138	$ –
State	14,509	295	(33,423)
Total	31,653	10,433	(33,423)
Deferred – Net:			
Reclassification due to net operating loss	227,278	32,078	(209,799)
Tax gain on sale/leaseback of Grand Gulf 1	(126,286)	–	–
Rate deferrals	102,789	137,721	383,180
Other deferred purchased power costs	(3,397)	17,396	11,091
Gas contract settlements	(69,201)	1,037	81,096
Liberalized depreciation	71,785	166,272	274,790
Amortization of excess deferred income taxes	(22,644)	(23,468)	(3,954)
Unbilled revenue	(20,455)	(12,530)	730
Customer deposits	13,976	–	(1,022)
Accrued research expenses	2,493	(2,493)	–
Bond reacquisition costs	–	9,080	–
Nuclear refueling and maintenance	11,827	(9,328)	2,178
Deferred fuel	11,498	(2,222)	8,082
Deferred revenue and related interest	(1,817)	(8,660)	12,585
Alternative minimum tax	75	(32,302)	–
Other	(1,086)	(3,148)	6,045
Total	196,835	269,433	565,002
Investment tax credit:			
Amortization	(17,799)	(5,246)	(5,019)
Provision	30,189	–	–
Recorded income tax expense	$240,878	$274,620	$526,560
Charged to operations	$255,427	$299,538	$549,216
Credited to other income	(14,549)	(24,918)	(22,656)
Recorded income tax expense	240,878	274,620	526,560
Income taxes applied against the debt component of AFUDC	(8,520)	(2,545)	(3,157)
Total income taxes	$232,358	$272,075	$523,403

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):

	1988		1987		1986	
	Amount	*% of Pre-Tax Income*	*Amount*	*% of Pre-Tax Income*	*Amount*	*% of Pre-Tax Income*
Computed at statutory rate	$251,149	34.0	$289,281	40.0	$492,967	46.0
Increases (reductions) in tax resulting from:						
Amortization of excess deferred income taxes	(22,644)	(3.1)	(23,468)	(3.2)	(3,954)	(0.3)
Write-off of LP&L's state-deferred taxes related to depreciation timing differences	–	–	(23,828)	(3.3)	–	–
State income taxes net of federal income tax effect	4,833	0.7	16,251	2.2	28,185	2.7
Investment tax credit amortization	(17,758)	(2.4)	(5,157)	(0.7)	(5,044)	(0.4)
Depreciation	17,198	2.3	25,659	3.5	21,536	2.1
Other – net	8,100	1.1	(4,118)	(0.5)	(7,130)	(1.0)
Recorded income tax expense	240,878	32.6	274,620	38.0	526,560	49.1
Income taxes applied against the debt component of AFUDC	(8,520)	(1.1)	(2,545)	(0.4)	(3,157)	(0.3)
Total income taxes	$232,358	31.5	$272,075	37.6	$523,403	48.8

NOTE 4. LINES OF CREDIT AND RELATED BORROWINGS

On December 1, 1988, System Energy consummated certain remarketing arrangements relating to its Series A and Series C Pollution Control Revenue Bonds. In connection with this remarketing program, the separate bank letters of credit that had been issued in support of each series were terminated, and approximately $193.6 million of funds that had been held on deposit in an escrow account for the benefit of the banks providing the letter of credit for the Series C Pollution Control Revenue Bonds were released. System Energy applied a portion of the escrow funds, together with other available funds, to prepay in full the $81.92 million and $32.25 million of borrowings remaining outstanding under its U.S. and foreign bank loan agreements, respectively, thereby terminating these agreements. The termination of these agreements resulted in the expiration of a number of financial covenants and restrictions binding upon System Energy, including an agreement by System Energy not to pay any dividends on its common stock to MSU until all loans outstanding thereunder were fully paid.

The System operating companies and System Energy are authorized through 1990 by the SEC to effect short-term borrowings in an aggregate amount outstanding at any one time of up to a specified dollar amount for each company (AP&L – $125 million; LP&L – $125 million; MP&L – $100 million; NOPSI – $30 million; and System Energy – $125 million), subject to increase to a maximum of 10% of each company's respective capitalization with further SEC approval. However, the ability of each of the System operating companies and System Energy to borrow is subject to the availability of funds through bank lines and other credit sources. System Energy is limited by one of its credit arrangements to short-term borrowings in an aggregate amount not exceeding 5% of capitalization (approximately $234.8 million at December 31, 1988). MP&L and NOPSI are limited by the terms of their respective indentures providing for the issuance of G&R bonds to short-term borrowings in an aggregate amount not exceeding, in general, the greater of 10% of capitalization or 50% of Grand Gulf 1 rate deferrals available to support the issuance of G&R bonds. In addition, LP&L, MP&L, and NOPSI are subject to an SEC order which prohibits incurrence of short-term indebtedness if common stock equity is, or would thereby become, less than 30% of the sum of total capitalization plus short-term indebtedness. As a result of the $135 million write-off of previously deferred Grand Gulf 1-related costs and the reduction of NOPSI's common stock equity caused thereby (19.3% of total capitalization as of December 31, 1988), NOPSI is currently precluded from effecting any short-term borrowings, whether through bank loans or money pool borrowings, without further SEC approval, which is not likely to be obtained under the present circumstances.

The System operating companies, excluding NOPSI, have lines of credit, not requiring commitment fees, providing for short-term borrowings of $140.6 million through loans from banks within their service territory. Additionally, the four System operating companies, together with MSU, System Energy, 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. The maximum borrowing and average borrowing by participants from the System money pool during 1988 were $26.4 million and $21.9 million, respectively. At December 31, 1988, the funds available in the money pool for borrowing aggregated $619.0 million. In addition, SSI has a line of credit with MSU for $30 million through December 31, 1989.

At December 31, 1988, SFI had a fuel oil financing arrangement allowing for borrowings of up to $40 million, subject to a limit equivalent to the lower of the cost or the fair market value of SFI's fuel oil inven-

Credit facilities (excluding the money pool) at December 31, 1988, 1987, and 1986 and borrowings thereunder of the System companies were as follows:

Years Ended December 31,	*1988*		*1987*		*1986*	
	Credit Facilities	*Borrowings*	*Credit Facilities*	*Borrowings*	*Credit Facilities*	*Borrowings*
			(In Thousands)			
Short-term:						
System Energy	–	–	$158,000	$158,000	–	–
SFI	$105,000	$43,500	$105,000	$ 97,000	$170,000	$131,000
Operating subsidiaries	$140,588	$ 4,157	$220,800	–	$270,485	$ 5,000
Long-term:						
Company	–	–	$ 60,000	–	$ 60,000	–
System Energy	–	–	$374,349	$374,349	$709,450	$709,450
SFI	–	–	$ 50,000	–	$ 50,000	$ 18,000

tory and certain related receivables. SFI's borrowings under this fuel oil financing arrangement were $17.5 million at year-end. Effective January 31, 1989, this arrangement was terminated and replaced by a bank line of credit allowing for borrowings of up to $30 million. This new arrangement is scheduled to terminate in January 1992. In addition, at December 31, 1988, SFI had an arrangement to borrow up to $65 million in the aggregate through the sale of commercial paper for use in financing its nuclear fuel inventory. SFI had $26.0 million outstanding under this arrangement at December 31, 1988. Borrowings under these arrangements are restricted as to use and are secured by a portion of 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.

System short-term borrowings (excluding money pool borrowings) and the interest rates (determined by dividing applicable interest expense by the average amount borrowed) are given at right:

Years Ended December 31,	*1988*	*1987*	*1986*
	(Dollars in Thousands)		
Average Borrowing:			
Bank loans	$ 52,933	$ 12,665	$ 96,270
Commercial paper	$ 53,216	$ 72,738	$121,603
Other	$ 19,127	$173,558	$ 32,542
Maximum Borrowing:			
Bank loans	$100,805	$ 26,000	$125,160
Commercial paper	$ 65,000	$ 85,000	$125,000
Other	$ 32,667	$210,667	$ 49,135
Year-end Borrowing:			
Commercial paper	$ 26,000	$ 65,000	$105,000
Other	$ 21,657	$190,667	$ 31,000
Average Interest Rate:			
During period –			
Bank loans	9.3%	8.1%	8.9%
Commercial paper	9.1%	7.8%	8.1%
Other	10.4%	9.4%	9.2%
At end of period –			
Commercial paper	9.3%	7.8%	7.4%
Other	11.0%	9.7%	8.6%

NOTE 5. PREFERRED STOCK

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

At December 31,	*Shares Authorized 1988*	*Shares Outstanding 1988*	*Shares Outstanding 1987*	*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	$102.80 to $105.28
9.16% - 11.48%	795,000	795,000	795,000	$104.06 to $111.11
Total	3,045,774	3,045,106	3,045,106	
With sinking fund:				
8.52% - 9.76%	1,200,000	1,200,000	1,200,000	$108.52 to $109.00
10.60% - 12.00%	373,000	373,000	431,337	$106.74 to $109.00
14.75% - 17.00%	266,995	266,995	266,995	$111.58 to $116.16
Total	1,839,995	1,839,995	1,898,332	
Unissued	5,358,500			
Total	10,244,269			
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	$27.30
Total	1,000,000	1,000,000	1,000,000	
With sinking fund:				
9.92% - 12.64%	5,276,063	5,276,063	5,671,871	$27.01 to $27.56
13.12% - 15.20%	4,645,823	4,645,823	5,258,168	$27.46 to $29.05
19.20%	2,000,000	2,000,000	2,000,000	$27.67
Total	11,921,886	11,921,886	12,930,039	
Unissued	15,373,396			
Total	28,295,282			
Cumulative, $0.01 par value				
Unissued	15,000,000			
Total	15,000,000			

NOTES TO FINANCIAL STATEMENTS

Middle South Utilities, Inc. and Subsidiaries

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

	Number of Shares		
	1988	*1987*	*1986*
Sales:			
AP&L			
8.52%, $100 par	–	–	500,000
MP&L			
9.00%, $100 par	–	–	350,000
9.76%, $100 par	–	350,000	–
Retirements:			
AP&L			
9.92%, $25 par	(137,043)	(111,000)	(18,000)
10.60%, $100 par	(18,012)	(13,880)	–
11.04%, $100 par	(35,325)	(24,675)	(37,572)
13.28%, $25 par	(200,175)	(280,325)	–
LP&L			
10.72%, $25 par	(93,635)	(480,000)	(119,750)
12.64%, $25 par	(165,130)	(134,500)	–
13.12%, $25 par	(291,390)	(202,489)	(85,000)
14.72%, $25 par	(900)	(366,684)	–
15.20%, $25 par	(119,880)	(119,960)	(65,000)
MP&L			
12.00%, $100 par	(5,000)	–	–
14.75%, $100 par	–	–	(100,000)
17.00%, $100 par	–	–	(200,000)
NOPSI			
15.44%, $100 par	–	(18,000)	(100)
Total	(1,066,490)	(1,401,513)	224,578

The amounts of preferred stock of the System operating companies as of the end of the last two years were as follows:

December 31,	*1988*	*1987*
	(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	$184,000	$189,834
Stated at $25 a share	298,047	323,250
Premium	567	645
Issuance and discount expense	(19,649)	(17,324)
Total with sinking fund	$462,965	$496,405

Cash sinking fund requirements for the ensuing five years for preferred stock outstanding at December 31, 1988, are as follows (in thousands): 1989 – $22,250; 1990 – $32,250; 1991 – $41,750; 1992 – $41,750; and 1993 – $48,750.

All of the System operating companies were current with respect to their quarterly preferred stock dividend payments through January 1, 1989. As a consequence of the February 4 Resolution, the elimination of NOPSI's retained earnings due to the write-off of $135 million of Grand Gulf 1-related costs in 1987, and the recording of an accumulated deficit, NOPSI's Board of Directors did not declare the regular April 1, July 1, and October 1, 1988, quarterly dividends on preferred stock, aggregating approximately $2.1 million. In November 1988, NOPSI's Board of Directors (1) with the consent of MSU as NOPSI's common stockholder, effected a recapitalization program pursuant to which NOPSI restructured its common stock accounts and eliminated the prior deficit as of November 30, 1988, and (2) declared for payment on January 1, 1989, the dividends in arrears and the regular quarterly preferred dividend payable on January 1, 1989. Such dividends, aggregating approximately $2.8 million, were paid as of January 1, 1989.

NOTE 6. LONG-TERM DEBT

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

December 31,	*1988*	*1987*
	(In Thousands)	
First mortgage bonds	$4,773,910	$4,809,293
General and refunding bonds – due 1993-97, 10.95% – 14.95%	190,000	75,000
Bank notes:		
Due:		
1989, at 110% of the sum of prime and 1.3%	–	247,599
1989, at LIBOR plus 2%	–	126,750
Total bank notes	–	374,349
Other:		
Long-term obligation – Department of Energy (Note 8)	75,733	71,106
Municipal revenue bonds – due serially through 2004, 1-1/4% – 8%	23,397	26,344
Pollution control revenue bonds and installment purchase contracts:		
Due serially through 2014, 6.4% – 9.5%	59,770	60,870
Due 1995-2016, 5-1/4% – 12-1/2%	896,225	896,225
Purchase obligations under inventory supply agreement	27,997	25,110
Grand Gulf 1 lease obligation, 9.8% (Note 9)	500,000	–
Total other	1,583,122	1,079,655
Unamortized premium and discount – net	(53,244)	(56,861)
Total long-term debt	6,493,788	6,281,436
Less – amount due within one year	306,346	336,382
Long-term debt excluding amount due within one year	$6,187,442	$5,945,054

Maturities and sinking fund requirements for the ensuing five years on long-term debt outstanding at December 31, 1988, are as follows:

	Maturities	*Sinking Fund Requirements*	
		Cash	*Other****
	(In Thousands)		
1989	$251,946*	$54,400	$21,798
1990	$ 54,777**	$54,400	$21,798
1991	$342,222	$69,300	$21,328
1992	$276,558	$69,300	$21,248
1993	$403,005	$58,050	$36,828

**Includes $27.1 million and $220 million of System Energy and LP&L, respectively, pollution control revenue bonds expected to be remarketed in 1989.*

***Excludes potential obligation of NOPSI to purchase up to $115 million of G&R bonds (see Note 8 – "Commitments and Contingencies – NOPSI Prudence Disallowance and Other Controversies Concerning Grand Gulf 1").*

****Sinking fund requirements may be met by certification of property additions at the rate of 167% of the required amount.*

On December 28, 1988, System Energy entered into arrangements for the sale and leaseback of an approximate 11.5% ownership interest in Grand Gulf 1 for an aggregate cash consideration of $500 million. (See Note 9 – "Leases" for further information on these arrangements.) The net proceeds received by System Energy were placed on deposit with System Energy's mortgage trustee until January 22, 1989, at which time System Energy used the proceeds to redeem $300 million of its First Mortgage Bonds, 16% Series due 2000, $100 million of its First Mortgage Bonds, 15-3/8% Series due 2000, and $87.697 million of its First Mortgage Bonds, 11-3/8% Series due 2016, in each case at the redemption price of 100% of the principal amount plus accrued interest to the date of redemption. The following amounts of future sinking fund requirements, which were included in the table at left, were eliminated upon the redemption of the above series of outstanding first mortgage bonds: 1989 – $53.5 million; 1990 – $53.5 million; 1991 – $38.5 million; 1992 – $38.5 million; and 1993 – $27.25 million.

The outstanding first mortgage bonds of the Company's subsidiaries as of December 31, 1988 and 1987, were:

Maturity	*4-1/8%-5-7/8%*	*6%-8-7/8%*	*9%-11-7/8%*	*12%-14-7/8%*	*15%-16%*	*Total*
			(In Thousands)			
1988						
1989	–	–	–	–	–	–
1990	$ 20,600	–	–	–	$ 30,000	$ 50,600
1991	$ 27,000	–	$300,000	–	–	327,000
1992	$ 8,000	–	–	$265,000	–	273,000
1993	$ 15,000	–	$200,000	$100,000	–	315,000
1994-2003	$236,250	$461,560	$785,500	$215,000	$500,000	2,198,310
2004-2013	–	$ 85,000	$450,000	$250,000	–	785,000
2014-2016	–	–	$600,000	$190,000	$ 35,000	825,000
Total first mortgage bonds						$4,773,910
1987						
1988	$ 15,283	–	$ 45,000	–	–	$ 60,283
1989	–	–	$ 45,000	–	–	45,000
1990	$ 20,700	–	–	–	$ 30,000	50,700
1991	$ 27,000	–	$300,000	–	–	327,000
1992	$ 8,000	–	–	$265,000	–	273,000
1993-2002	$251,250	$287,160	$914,900	$315,000	$500,000	2,268,310
2003-2012	–	$260,000	$450,000	$ 75,000	–	785,000
2013-2016	–	–	$600,000	$365,000	$ 35,000	1,000,000
Total first mortgage bonds						$4,809,293

NOTE 7. RETAINED EARNINGS

The Public Utility 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 companies' long-term debt and preferred stock, respectively, and the provisions of certain of System Energy'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 companies 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. As of December 31, 1988, $1,185.2 million of consolidated retained earnings were free from such restrictions, including $785.0 million of unrestricted, undistributed retained earnings of the Company's subsidiaries. The unrestricted, undistributed retained earnings of any MSU subsidiary 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.

On each of September 30, 1988, and January 27, 1989, the MSU Board of Directors declared a common stock dividend of 20 cents per share, payable on December 1, 1988, and March 1, 1989, respectively. Prior to December 1, 1988, MSU had last paid a dividend in July 1985. Dividends on common stock had been omitted during the interim period due to the major uncertainties facing the System. The decision of MSU's Board of Directors to resume the declaration of common stock dividends reflects, among other things, the significant improvement in the financial position and prospects of the System occasioned by the June 24 Decision.

In December 1988, System Energy consummated various steps which resulted in the expiration of a number of financial covenants and restrictions binding upon System Energy, including, in particular, an agreement by System Energy not to pay any dividends on its common stock to MSU until all loans outstanding under its bank loan agreements were fully paid. In December 1988, System Energy paid a cash dividend on common stock of $300 million to its common stockholder, MSU. This dividend was the first ever paid by System Energy. On February 21, 1989, System Energy paid an additional cash dividend on its common stock to MSU of $47.3 million.

NOTE 8. COMMITMENTS AND CONTINGENCIES

At December 31, 1988, a number of significant uncertainties continued to face the System. A discussion of these matters follows under "NOPSI Prudence Disallowance and Other Controversies Concerning Grand Gulf 1," "FERC Audit of System Energy," and "Uncertainties Relating to Grand Gulf 2." In addition, the System's financial position could be affected by the outcome of the council's consideration of municipalization of NOPSI's electric and gas utility properties (see "NOPSI Municipalization" herein).

NOPSI Prudence Disallowance and Other Controversies Concerning Grand Gulf 1

On February 4, 1988, after a lengthy prudence investigation, the council adopted the February 4 Resolution that required NOPSI to write off, and not recover from its retail electric customers, $135 million of its previously deferred Grand Gulf 1-related costs, in addition to the $51.2 million of such costs that NOPSI absorbed as part of its rate settlement. NOPSI is seeking relief in federal and state courts from the action of the council (see Note 2 – "Rate and Regulatory Matters").

In the meantime, the February 4 Resolution will continue to have a substantial and adverse effect upon NOPSI's financial condition and to constrain NOPSI's cash flow. Specifically, the $135 million disallowance was written off, net of income taxes, and reflected as a loss in 1987. Should the February 4 Resolution remain in effect, NOPSI would have its future revenues over the period of the rate settlement reduced not only by the $135 million disallowance, but also by the loss of the accumulated carrying charges that would have been recoverable on the deferred amounts written off, which could amount to an additional $165 million over that period.

The consequences of the February 4 Resolution, so long as it remains in effect, are that NOPSI's ability to effect long- or short-term external borrowings or to satisfy potential obligations to purchase all or a portion of its outstanding G&R bonds (as discussed herein) will continue to be significantly and adversely affected, and NOPSI could ultimately be rendered insolvent. In this connection, NOPSI has continued to retain independent special counsel experienced in bankruptcy matters to help evaluate the options available to NOPSI.

In order to mitigate the negative effects upon NOPSI's financial condition and cash flow caused by the February 4 Resolution and thereby reduce the risk of insolvency, NOPSI has implemented a series of cash conservation and other measures. In this connection, commencing in April 1988, NOPSI has deferred, from time to time for limited periods (in each case less than 30 days), its monthly payment to System Energy under the Unit Power Sales Agreement covering NOPSI's monthly payment obligations for capacity and energy from Grand Gulf 1. NOPSI may defer, as needed, from time to time in the future, its monthly payments to System Energy for similar periods in order to conserve cash. [The failure of NOPSI to make any monthly payment to System Energy under the Unit Power Sales Agreement within 30 days after such payment is due could result in acceleration of System Energy's obligations in respect of its Series B Pollution Control Revenue Bonds (PCRBs) (currently outstanding in the amount of $27.1 million), unless waivers were obtained or other arrangements were negotiated.] In addition, NOPSI terminated its pension plan, effective October 1, 1988, resulting in the reversion to NOPSI in January 1989 of approximately $16.7 million. (See Note 10 – "Postretirement Benefits.")

In view of the fact that NOPSI was not able to obtain a timely court injunction staying enforcement of the February 4 Resolution, NOPSI was required, by the terms of its 1987 mortgage indenture, to cause an independent arbiter to deliver to the trustee for the holders of NOPSI's $115 million of outstanding G&R bonds a certificate as to whether, in the independent arbiter's opinion, the February 4 Resolution has materially impaired or will materially impair NOPSI's ability to perform its obligations in respect of the outstanding G&R bonds. In a certificate dated June 24, 1988 (arbiter's report), the independent arbiter concluded, based upon the hypothetical assumption that the February 4 Resolution would not be reversed by the courts and upon certain related assumptions of NOPSI's management regarding future events, that NOPSI's projected cash flows during certain future periods "appear to be insufficient to cover projected regularly scheduled debt service requirements when required." Because the arbiter's report indicated that the February 4 Resolution would materially impair NOPSI's ability to perform its obligations in respect of the outstanding G&R bonds, any holder thereof had the option, through August 11, 1988, to require NOPSI to redeem its G&R bonds on August 26, 1988, at a price of 100% of the principal amount plus accrued interest to the date of redemption.

However, NOPSI successfully negotiated with its G&R bondholders two extensions of the right to tender their bonds to NOPSI such that the G&R bondholders now have the right to tender their G&R bonds between November 24 and December 13, 1989, for purchase on February 9, 1990. The G&R bondholders would not have the right to give notice between November 24 and December 13, 1989, and NOPSI would not be required to purchase any G&R bonds on February 9, 1990, if an independent arbiter has delivered on or prior to November 23, 1989, a certificate stating that the impairment of NOPSI's ability to perform its obligations in respect of the G&R bonds, described in the arbiter's report, has ceased because of judicial or regulatory action.

While NOPSI believes that the June 24 Decision represents a very favorable development in terms of NOPSI's ability to obtain ultimate reversal of the February 4 Resolution, there is no assurance that the matter

will be favorably resolved by November 1989 and that one or more G&R bondholders will not demand purchase of their G&R bonds. If this were to occur and any significant amount of G&R bonds were tendered for purchase, there is no assurance that NOPSI would have sufficient available cash resources or financing capabilities at that time to meet its purchase obligations. As a result, NOPSI could ultimately be rendered insolvent unless such obligations were deferred, restructured, or other arrangements negotiated.

Insolvency of NOPSI, should it occur, could result in acceleration of System Energy's obligations relating to its Series B PCRBs, unless waivers were obtained or other arrangements were negotiated. Also, certain of SFI's financing agreements and leases may require payments by the System operating companies or MSU in the event that SFI's obligations under such agreements are accelerated as a result of the insolvency of NOPSI, and in the event that SFI is unable to meet these obligations or to otherwise satisfy these obligations through the sale of the collateral securing such obligations. In addition, insolvency of NOPSI could affect the terms of financing, including an increase in the cost of financing, or could preclude financing for other System companies.

In addition to the NOPSI proceedings (discussed herein), litigation is continuing regarding FERC's Grand Gulf 1 allocation. The June 13 Decision, whereby FERC allocated the capacity and energy from System Energy's share of Grand Gulf 1 and the costs associated therewith among the System operating companies, was reaffirmed by FERC in its November 30, 1987, order. However, the November 30 Order has been appealed by various parties to the D.C. Circuit, where the matter is still pending. Further, various state and local regulatory bodies have been considering initiating a proceeding before FERC regarding various Grand Gulf 1 prudence issues. (See Note 2 – "Rate and Regulatory Matters – U.S. Supreme Court Decision.")

FERC Audit of System Energy

FERC has performed an audit of System Energy and the Grand Gulf Station as part of its regulatory function in auditing utilities subject to its jurisdiction. The audit report, which pertains to the period from System Energy's inception through December 31, 1985, was issued on June 18, 1987. In the report, as updated by FERC staff (staff) testimony, the staff states, among other things, that the Grand Gulf Station's AFUDC is overstated by $126.5 million ($99.8 million relating to Grand Gulf 1 and $26.7 million relating to Grand Gulf 2) because the "AFUDC calculation failed to take into account all cost-free capital generated by System Energy expenditures and claimed on consolidated income tax returns." The staff recommends that System Energy change its income tax accounting procedures and record an accounting entry to charge the alleged AFUDC overstatement arising from System Energy's alleged incorrect accounting against net income, recompute billings to customers since July 1, 1985, to reflect adjusted plant and equity balances, and refund, with interest, the difference between the recomputed billings and amounts previously charged customers. Further, the staff recommends that $327.2 million of "Recoverable Taxes," representing a significant portion of System Energy's unrealized recorded income tax benefits, should be reclassified to "Accounts Receivable from Associated Companies," the net effect of which would be a $258.1 million reduction of Grand Gulf 1's rate base on which System Energy earns a return. The staff recommends that System Energy refund, with interest, the change in billings since July 1, 1985, due to this rate base reduction.

System Energy has strongly disagreed with the staff's position, asserting that the staff's position is in violation of the SEC's tax allocation regulations applicable to holding company systems and contrary to FERC's own accounting rules. This matter is being litigated in an administrative proceeding at FERC. Various parties, including the APSC, the LPSC, the MPSC, and the council, have intervened in this proceeding. Hearings on this matter have concluded. Briefs have been scheduled for filing between February 7, 1989, and April 18, 1989. System Energy filed its brief on February 7, 1989. Oral arguments are scheduled to begin on April 25, 1989.

If certain of the staff's findings are ultimately sustained, the resulting charges against net income and refund requirements would have a material adverse impact on System Energy. System Energy estimates that, as of December 31, 1988, the impact on net income could be as high as approximately $300 million (net of tax effect), and System Energy could be obligated to refund approximately $290 million (inclusive of interest) to its customers, the System operating companies. In addition, the staff's proposed adjustments would adversely impact System Energy's prospective earnings, cash flow, and financial condition. System Energy cannot predict the ultimate outcome of the examination. The effect on the System if the staff's findings are ultimately sustained and refunds to the System operating companies are required would depend upon the associated retail rate treatment.

Uncertainties Relating to Grand Gulf 2

As recorded on its balance sheet as of December 31, 1988, System Energy's total investment in Grand Gulf 2 was approximately $905 million (including approximately $401 million of AFUDC). From late 1979 until September 1985, only a limited amount of construction was performed on Grand Gulf 2. Effective September 18, 1985, System Energy suspended construction activities on Grand Gulf 2 following an MPSC order. As of that date, Grand Gulf 2 was approximately 34% complete based on the man-hours estimated at that time to be needed to complete the unit.

Since September 1985, System Energy has limited expenditures to only those activities which are necessary for demobilization and suspension of the unit. A special group of System officials and outside

consultants completed, in late November 1986, its evaluation and review of Grand Gulf 2. Among the possibilities evaluated were (1) immediate resumption of construction of the unit, (2) cancellation of the unit, (3) continued suspension of construction of the unit through 1989 or beyond, and (4) conversion of the unit to an alternative fuel source. In December 1986, System Energy's Board of Directors (with the MSU Board of Directors concurring) adopted the group's recommendation that suspension of construction be continued and that a further decision be made by 1990 on the future status of Grand Gulf 2 in light of alternatives available at that time.

During the period of suspension, System Energy's expenditures on Grand Gulf 2 have continued to be limited, and System Energy, during this time, has not accrued AFUDC on its investment in the unit. Consequently, during the suspension period, System Energy has foregone any return on this investment. Further, System Energy has previously indicated that it has no intention, prior to a further decision on the status of Grand Gulf 2, of seeking FERC approval for the recovery through charges to the System operating companies of its investment in the unit.

System Energy is continuing to evaluate various alternatives for the future of Grand Gulf 2 and to assess whether the equipment and facilities constructed and acquired to date should continue to be carried at their full cost. In this connection, in 1989 System Energy will analyze the future status of Grand Gulf 2, including an evaluation of various possibilities similar to those studied in 1986. Any determination that the value of System Energy's investment should be reduced and the amount of any such reduction written off could adversely affect various companies in the System. Certain issues relating to the value of System Energy's investment in Grand Gulf 2 also exist in connection with an audit by FERC of System Energy and the Grand Gulf Station discussed herein in "FERC Audit of System Energy."

While System Energy believes that all of its investment to date in Grand Gulf 2 has been prudent, in connection with any further decision as to the value of Grand Gulf 2 or the ultimate decision with respect to the future of Grand Gulf 2, System Energy will, at an appropriate time, make a determination as to the appropriate recovery of all or a portion of its investment, including, in the event of cancellation of the unit, the possibilities of seeking recovery. In making such determination, System Energy will consider, among other things, the regulatory environment generally, legal standards then applicable, and the anticipated financial, regulatory, and political effects upon System Energy and the other System companies of various alternatives.

In the event that System Energy ultimately were to seek recovery of Grand Gulf 2 costs, it would likely be required to make a filing with FERC requesting such recovery over a period of years through charges to the System operating companies. The System operating companies would in turn be required to file applications with state or local regulatory authorities to recognize the FERC-allocated Grand Gulf 2 charges in retail rates. In view of the controversies over the Grand Gulf Station, including the adverse reaction of various rate regulatory bodies to allocation of costs, regulatory uncertainties, including ratemaking, attendant to a delay in the decision as to the future of Grand Gulf 2 and imprudence issues, there can be no assurance that the cost of Grand Gulf 2 will be recovered or as to the timing of any recovery. As was the case with Grand Gulf 1, proceedings before FERC and, with respect to recognition in retail rates of FERC-approved rates, before state or local regulatory authorities could be protracted and strongly contested on various grounds, including imprudence. If costs associated with Grand Gulf 2 were allocated to the System operating companies and they were unable to recover these costs from their customers, the System operating companies' financial condition could be materially and adversely affected. Any nonrecovery of System Energy's investment in Grand Gulf 2 would result in a charge against current income for any unrecoverable investment when that event becomes probable. In the event such a charge were substantial, the financial condition of System Energy could be materially and adversely affected and System Energy's ability to pay dividends on its common stock could be impaired.

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 System Energy, MSU, and, possibly, the System operating companies, depending upon, among other things, the timing of the realization of any such loss.

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

In December 1986, FASB issued SFAS No. 90, Regulated Enterprises – Accounting for Abandonments and Disallowances of Plant Costs, an amendment of SFAS No. 71. SFAS No. 90 requires, among other things, that, when abandonment of a plant becomes probable, the cost of such plant in excess of the present value of estimated recoveries through rates with respect

thereto, net of related tax benefits, shall be reported by recording a charge against current income. The provisions of SFAS No. 90 would apply should System Energy decide to cancel Grand Gulf 2 or should cancellation of Grand Gulf 2 become probable.

NOPSI Municipalization

The council, in connection with controversies surrounding the allocation of capacity and energy costs of the Grand Gulf Station, has been considering the municipalization by the City of New Orleans of the electric and gas utility properties of NOPSI and the electric utility properties 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 purpose, among others, of acquiring and operating electric power utilities in the City of New Orleans. The council has also received various reports from legal, engineering, and financial advisors with respect to the potential municipalization of NOPSI's electric utility facilities. These reports have asserted, among other things, that such municipalization could be accomplished without the city being required to assume NOPSI's obligations with respect to its FERC-allocated share of Grand Gulf 1 capacity and energy. NOPSI believes that any attempt by the city to municipalize NOPSI's electric utility facilities in order to attempt to enable electric customers in the city to avoid paying their federally allocated share of Grand Gulf 1-related costs could result in extensive and complex proceedings before various regulatory authorities and the courts, all of which could take many years to resolve. The February 4 Resolution, if not reversed, could have the effect of reducing the purchase price under municipalization by $135 million.

Condemnation or other involuntary taking of substantially all of the property of any System operating company might cause acceleration of a substantial portion of System Energy's indebtedness (but only upon further action by or on behalf of System Energy's creditors), unless waivers were obtained, the debt were restructured, or other arrangements were made.

On March 29, 1988, the council proposed to MSU to discuss a "friendly buyout" of NOPSI by the city. MSU responded by indicating a willingness to consider any alternatives that the council might propose if they are in the best interests of its stockholders, customers, and employees. Representatives of NOPSI and MSU are continuing to meet with members of the council and their consultants to discuss these matters. The ultimate outcome of these discussions cannot be predicted.

Capital Requirements and Financing

Capital requirements of the System during the period 1989-91 include (1) construction expenditures, (2) costs associated with rate phase-in plans, and (3) costs of nuclear fuel in addition to amounts leased under nuclear fuel leases. Construction expenditures (excluding nuclear fuel) during the years 1989, 1990, and 1991 are estimated to aggregate approximately $393.0 million, $416.0 million, and $411.5 million, respectively. Capital requirements associated with rate phase-in plans are estimated at $180.6 million, $97.0 million, and $(30.0) million for 1989, 1990, and 1991, respectively. It is also estimated that approximately $26.1 million will be required in 1989 to acquire nuclear fuel in addition to amounts financed under lease. The foregoing estimates are based on a number of assumptions, including certain assumptions and judgments with respect to, among other things, earnings, dividends, the outcome of regulatory and judicial proceedings, financing plans, and access to capital markets. Accordingly, depending upon the occurrence of future events, material changes in capital requirements could result.

In addition to the capital requirements described herein, the System operating companies and System Energy will require funds of approximately $537.2 million during the period 1989-91 to refinance maturing long-term debt and to meet sinking fund requirements. Additionally, NOPSI could be required to purchase up to $115 million of its outstanding G&R bonds on February 9, 1990. (See "NOPSI Prudence Disallowance and Other Controversies Concerning Grand Gulf 1" herein.) Further, System Energy and LP&L expect to remarket $27.1 million and $220 million, respectively, of pollution control revenue bonds in 1989. To the extent such remarketing is not successful, System Energy and LP&L may be required to reacquire such bonds, resulting in additional financing requirements. Finally, SFI plans to replace a nuclear fuel financing arrangement in 1989. To the extent this arrangement is not extended or replaced, additional financing requirements of up to $65 million could result.

The System's capital and refinancing requirements in the period 1989-91 are expected to be met primarily with internally generated funds. However, a number of uncertainties continue to confront the System, and, depending upon the ultimate resolution of such uncertainties and the effects thereof upon the System operating companies and System Energy, additional funds from external sources may be required. System Energy anticipates that its projected internally generated funds for the period 1989-91 will enable it to largely satisfy its cash requirements. AP&L, LP&L, and MP&L will require limited amounts of external financing during the period. NOPSI also will require external financing during the period 1989-91, which it hopes to be able to obtain through a combination of means, including sales of G&R bonds, the making of short-term borrowings, and the sales of such other securities and the effecting of such other financings as may be determined to be appropriate under the circumstances. However, as noted under "NOPSI Prudence Disallowance and Other Controversies Concerning Grand Gulf 1," NOPSI's ability to obtain funds from external sources is severely limited at this time.

Capital Funds, Unit Power Sales, Availability, and Reallocation Agreements

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

Pursuant to the allocation specified in the Unit Power Sales Agreement among System Energy and the System operating companies as ordered by FERC in the June 13 Decision, System Energy has agreed to sell to the System operating companies all of its 90% share of the capacity and energy from Grand Gulf 1 in accordance with specified percentages (AP&L – 36%, LP&L – 14%, MP&L – 33%, and NOPSI – 17%). Charges under the Unit Power Sales Agreement, which are computed monthly, are based on System Energy's total cost of service, including System Energy's operating expenses, depreciation, and capital costs.

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 in amounts which, when added to any amounts received by System Energy under the Unit Power Sales Agreement or otherwise, are adequate to cover all of the operating expenses, including depreciation and interest charges, of System Energy. System Energy has, with the consent of the System operating companies, assigned its rights to payment and advances from the System operating companies under the Availability Agreement to certain creditors.

In November 1981, the System operating companies entered into the Reallocation Agreement which would have allocated the capacity and energy available to System Energy 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, with AP&L relinquishing its rights to capacity and energy from the Grand Gulf Station. Each of the System operating companies, including AP&L, would, however, have remained primarily liable to System Energy and its assignees for payments or advances under the Availability Agreement and the assignments thereof. 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, FERC's June 13 Decision allocating a portion of Grand Gulf 1 capacity and energy to AP&L and FERC's November 30, 1987, order supersedes the Reallocation Agreement insofar as it relates to Grand Gulf 1. (See Note 2 – "Rate and Regulatory Matters" for further information.)

Stockholder Litigation

MSU and certain other System companies and individuals are defendants in a purported consolidated class action suit. The initial complaint was filed on August 19, 1985, by an MSU stockholder (purporting to represent a class that purchased MSU common stock). Four similar complaints were filed on August 20, 1985; August 23, 1985; September 6, 1985; and September 19, 1985, respectively, by MSU stockholders (purporting to represent classes that purchased MSU common stock). The five actions were consolidated in the U.S. District Court for the Eastern District of Louisiana (district court). The consolidated, amended, and supplemental complaint alleges 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 prays for compensatory and punitive damages, legal costs and fees, and other proper relief against MSU, System Energy, LP&L, MP&L, AP&L, and NOPSI; certain current and former members of MSU's Board of Directors, and certain current and former officers of MSU, System Energy, LP&L, MP&L, AP&L, and NOPSI; the independent auditor of MSU; and certain underwriters of MSU common stock. On March 14, 1986, the plaintiffs in the consolidated action filed a motion for class action determination. On April 18, 1986, MSU and certain other System companies and individual 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. On June 7, 1988, the Fifth Circuit rendered a decision vacating the judgment of the district court, based, in part, on the conclusion that the district court had not adequately explained the bases for its decision. In remanding the case to the district court for further proceedings, the Fifth Circuit suggested that the district court could again consider the merits of the defendants' motion for summary judgment and determine, with the benefit of certain guidelines as to the interpretation of governing law articulated by the Fifth Circuit, whether the

defendants are entitled to summary judgment as a matter of law. The district court was directed, if it makes such a determination, to provide a detailed analysis supporting its conclusions that would facilitate judicial review. Alternatively, the Fifth Circuit noted, the district court could decline to rule on the defendants' motion for summary judgment until further development of the case has taken place and the issues have been narrowed through the available pretrial techniques. On September 6, 1988, defendants filed a petition for a writ of certiorari with the U.S. Supreme Court. On October 31, 1988, the Court denied this petition. Based upon the Fifth Circuit's decision, the district court allowed the parties to rebrief the motion for summary judgment, and on January 17, 1989, the defendants filed a renewed motion for summary judgment and a verified answer to the consolidated, amended, and supplemental complaint. The district court has scheduled the trial to commence March 12, 1990. The outcome of this pending matter and its impact on the System's financial condition cannot be predicted.

Fuel Contracts

The System has long-term contracts for the supply of coal for the White Bluff Station and the Independence Station. Coal for the White Bluff Station is supplied under a contract providing for the deliveries of coal from a mine being operated in the state of Wyoming in amounts sufficient for the operation of the White Bluff Station through approximately 2002. Coal for the Independence Station is being provided under a contract with a joint venture operating another mine in the state of Wyoming. Coal supplied under this contract is expected to provide for the projected requirements of the Independence Station through approximately 2015. The System believes, therefore, that it will have adequate supplies of coal for its generating needs for the foreseeable future.

Nuclear Insurance

The Price-Anderson Act was amended in 1988 to extend its coverage to August 1, 2002, and to limit the public liability for a single nuclear incident to approximately $7 billion. AP&L, LP&L, and System Energy are protected against this liability by a combination of private insurance (presently $160 million; expected to increase to $200 million by the end of 1989) and an industry assessment program. Under the assessment program, for each nuclear incident at a licensed nuclear facility, each licensee will be responsible for up to $66 million per reactor (such amount to be indexed every five years for inflation), payable at a rate of $10 million per year, including a 5% surcharge in the event the total public liability approaches $7 billion. The System has a total of four licensed reactors.

AP&L, LP&L, and System Energy are members of certain insurance programs that provide coverage for property damage, including decontamination expense, to members' nuclear generating plants. These companies are insured against such losses up to $1.525 billion, $1.725 billion, and $1.725 billion, respectively. In addition, AP&L, LP&L, MP&L, and NOPSI are members of an insurance program that provides insurance coverage for certain costs of replacement power incurred due to certain prolonged outages of nuclear units. These coverages are subject to assessment provisions. At December 31, 1988, the maximum amounts of such assessments were: AP&L – $14.07 million, LP&L – $9.79 million, MP&L – $.36 million, NOPSI – $.22 million, and System Energy – $34.87 million.

The property insurance carried by AP&L, LP&L, and System Energy exceeds that required by the amended regulations dated October 5, 1987, by $465 million, $665 million, and $665 million, respectively. The Nuclear Regulatory Commission (NRC) regulations further provide that any proceeds of this insurance must be segregated in a trust and be used, first, to place and maintain the reactor in a safe and stable condition and, second, to complete required decontamination operations.

The NRC has issued, on behalf of all nuclear licensees, including AP&L, LP&L, and System Energy, temporary exemptions from the stabilization and decontamination priority and trusteeship provisions until completion of the pending rulemaking extending the implementation date of the regulations, but not later than April 1, 1989. It is anticipated that the temporary exemptions will be extended beyond that date.

Spent Nuclear Fuel and Decommissioning Costs

Under the Nuclear Waste Policy Act of 1982 (NWPA), the Department of Energy (DOE) is required to construct storage facilities for and dispose of all spent nuclear fuel and other high-level radioactive waste generated by domestic nuclear power reactors, for a specified fee. The NRC, pursuant to the NWPA, also requires operators of nuclear power reactors to enter into spent fuel disposal contracts with the DOE. The affected System companies have entered into such contracts with the DOE whereby it will furnish disposal service at a cost of one mill per kilowatt-hour of net generation after April 7, 1983, plus a one-time fee for generation prior to that date. AP&L, the only System company which generated nuclear power prior to that date, has elected to pay the one-time fee, plus accrued interest, no earlier than 1998, and had recorded at December 31, 1988, approximately $75.7 million (including accrued interest) for this payment. The fees payable to the DOE may be adjusted in the future to assure full cost recovery. AP&L, LP&L, and System Energy consider all costs incurred or to be incurred in connection with disposal of spent 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 authorities.

Under the NWPA, the DOE was to begin accepting spent fuel in 1998 and continue until the disposal of all fuel from reactor sites is accomplished. However, the DOE's repository program has been delayed, with estimated initial operation of a permanent repository scheduled for 2003. In the meantime, AP&L, LP&L, and

System Energy will be responsible for storage of spent fuel. These companies estimate that on-site spent fuel storage capacity at Arkansas Nuclear One (Units 1 and 2), Waterford 3, and Grand Gulf 1 will be sufficient to store fuel from normal operations until 1994, 1996, 2000, and 2003, respectively. It is expected that any additional storage capacity required due to, among other things, delay of the DOE repository program will be provided by the affected companies.

AP&L, LP&L, and System Energy are recovering decommissioning costs for the Arkansas Nuclear One (ANO) Station, Waterford 3, and Grand Gulf 1, respectively. With respect to total estimated decommissioning costs, the APSC has approved a total recovery of approximately $686 million for the ANO Station. Decommissioning costs for Waterford 3 are currently estimated to be approximately $203 million. In addition, System Energy has entered into an agreement with an outside engineering firm to conduct a new decommissioning cost study, which is anticipated to be completed in the second quarter of 1989.

NOTE 9. LEASES

General

Prior to 1987, the Company's operating subsidiaries accounted for leases entered into before 1983 as operating leases, consistent with the basis used in the ratemaking process. 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 pre-1983 capital leases required the recording of assets and liabilities on the balance sheet with respect to such leases. The recording of these capital leases did not affect the amounts reported as either expenses or net income.

At December 31, 1988, the System companies had capital leases and noncancelable operating leases (excluding nuclear fuel leases and the sale and leaseback transaction discussed herein) with minimum rental commitments as follows:

	Capital Leases	*Operating Leases*
	(In Thousands)	
1989	$ 32,895	$ 53,965
1990	32,451	51,294
1991	31,679	40,969
1992	27,997	35,574
1993	21,009	34,505
Years thereafter	153,643	179,516
Minimum rental commitments	299,674	$395,823
Less: Amount representing interest	134,746	
Present value of net minimum lease payments	$164,928	

Rental expense for capital and operating leases (excluding nuclear fuel leases and the sale and leaseback transaction) amounted to approximately $85.3 million, $77.6 million, and $76.6 million in 1988, 1987, and 1986, respectively.

Nuclear Fuel Leases

Three subsidiaries have nuclear fuel leasing arrangements. As of December 31, 1988, nuclear fuel leases aggregated $495.5 million. On December 22, 1988, AP&L entered into a new nuclear fuel lease which will permit the lease of up to $195 million of nuclear fuel. On February 3, 1989, and February 24, 1989, LP&L and System Energy also entered into new nuclear fuel leasing arrangements permitting the lease of up to $125 million and $185 million of nuclear fuel, respectively. Each lessor finances its acquisition and ownership of nuclear fuel under a credit agreement and through the issuance of intermediate term notes. The credit agreements all have terms of five years and the intermediate term notes have varying maturities of 1-1/2 to 10 years. It is contemplated that these credit arrangements will be extended or alternative financing will be secured by each lessor upon the maturity of the current arrangements, based on the particular lessee's nuclear fuel requirements. If a lessor cannot arrange for alternative financing upon the regularly scheduled maturity of its borrowings, the particular lessee must purchase nuclear fuel in an amount equal to the amount required by the lessor to retire such borrowings. All prior nuclear fuel leasing arrangements were effectively canceled with the start of the new nuclear fuel lease arrangements.

Lease payments are based on nuclear fuel use. Nuclear fuel lease expenses of $219.7 million, $190.8 million, and $161.4 million were charged to operations in 1988, 1987, and 1986, respectively. The unrecovered cost base of the leases was $396.1 million, $397.9 million, and $410.8 million at December 31, 1988, 1987, and 1986, respectively.

Sale and Leaseback Transaction

On December 28, 1988, System Energy entered into arrangements for the sale and leaseback of an approximate 11.5% ownership interest in Grand Gulf 1 for an aggregate cash consideration of $500 million. The sale was made to an owner trustee under two separate trust agreements with two owner participants. System Energy is leasing back the sold interest from the owner participants on a net lease basis over a 26-1/2-year basic lease term.

The owner trustee acquired the interest with funds provided by the owner participants and with funds borrowed on an interim basis by the owner trustee through the issuance of notes to interim lenders. It is anticipated that the interim debt will be refunded in the second quarter of 1989 with the proceeds from the issuance and sale of long-term bonds. The lease payments to be made by System Energy will be sufficient to service the debt

incurred by the owner trustee and to provide a return of and on investment to the owner participants.

With regard to the funds provided by the owner participants, letters of credit in the aggregate amount of $130 million have been provided by banks for the benefit of the owner participants to secure the payment of certain amounts payable by System Energy under the lease. Upon the occurrence of certain adverse events, the owner participants would be entitled to draw on the letters of credit in amounts sufficient to enable the owner participants to withdraw from the lease, but not in amounts sufficient to cover the debt of the owner trustee. Under these circumstances, System Energy would be obligated, pursuant to a reimbursement agreement between System Energy and the letter of credit banks, to repay amounts drawn under the letters of credit within a short period of time, and System Energy may be required to assume the debt of the owner trustee.

In May 1988, FASB issued SFAS No. 98, Accounting for Leases. Under SFAS No. 98, the letter of credit backing, described herein, meets the criteria of a "continuing involvement" by System Energy. As a result, the sale and leaseback transaction is accounted for as a financing transaction in System Energy's financial statements, in accordance with the provisions of SFAS No. 98. However, the transaction is accounted for as a sale and leaseback for regulatory and income tax purposes.

At December 31, 1988, System Energy had future minimum lease payments (reflecting an overall implicit rate of 9.8%) in connection with the sale and leaseback transaction as follows (approximate amounts in thousands):

1989	$ 27,254
1990	48,762
1991	48,761
1992	48,761
1993	48,761
Years thereafter	1,257,566
	$1,479,865

NOTE 10. POSTRETIREMENT BENEFITS

The System companies have various postretirement benefit plans covering substantially all of their employees. The pension plans are noncontributory and provide pension benefits that are based on the employees' credited service and average compensation, generally during the last five years before retirement. The policy of the Company and its subsidiaries is to fund pension costs in accordance with contribution guidelines established by the Employee Retirement Income Security Act of 1974, as amended.

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.

Effective October 1, 1988, NOPSI terminated its defined benefit pension plan and as of that same date adopted, as a participating employer, a defined benefit pension plan sponsored by LP&L. This successor plan provides employees with substantially the same benefit program with no loss of accrued benefits as provided under the terminated plan. In January 1989, the accumulated benefit obligation of the terminated plan was settled by purchasing annuity contracts. As a result, NOPSI recorded a settlement gain, net of applicable taxes, of approximately $9.1 million in January 1989 in accordance with the provisions of SFAS No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits. On January 31, 1989, NOPSI was refunded approximately $16.7 million (net of a 10% excise tax) from the terminated plan in excess of amounts required to purchase the annuity contracts, pay certain plan participants a pro rata portion (approximately $1.3 million) of excess plan assets as required by law, and satisfy other related costs and expenses connected with the settlement.

Total 1988 and 1987 pension cost of the Company and its subsidiaries, including amounts capitalized, included the following components:

	1988	*1987*
	(In Thousands)	
Service cost – benefits earned during the period	$16,391	$18,501
Interest cost on projected benefit obligation	40,504	38,280
Actual return on plan assets	(67,794)	(19,554)
Net amortization and deferral	5,167	(38,713)
1988 LP&L and NOPSI early retirement programs	12,150	-
Net pension cost (income)	$ 6,418	$ (1,486)

The assets of the plans consist primarily of common and preferred stocks, fixed income securities, interest in a money market fund, and insurance contracts.

The funded status of the Company's various pension plans at December 31, 1988 and 1987, is as follows:

	1988	1987
	(In Thousands)	
Actuarial present value of accumulated pension plan benefits:		
Vested	$390,477	$349,437
Nonvested	29,135	26,680
Accumulated benefit obligation	$419,612	$376,117
Projected benefit obligation	$518,360	$469,141
Plan assets at fair value	623,179	589,959
Plan assets in excess of projected benefit obligation	104,819	120,818
Unrecognized prior service cost	4,634	2,206
Unrecognized transition asset	(122,960)	(126,440)
Unrecognized net gain	(25,038)	(30,546)
Accrued pension liability	$(38,545)	$(33,962)

Total pension cost of the Company and its subsidiaries for 1988, 1987, and 1986 was $7.3 million, $1 million (1988 and 1987 amounts include miscellaneous immaterial adjustments not reflected in the above table), and $13.4 million, respectively. The Company and its subsidiaries adopted SFAS No. 87, Employers' Accounting for Pensions, effective January 1, 1987. Adoption of SFAS No. 87 reduced 1987 pension cost by approximately $9.3 million.

The weighted average discount rate and rate of increase in future compensation used in determining the 1988 and 1987 actuarial present value of the projected benefit obligation were 9.0% and 5.6%, respectively. The expected long-term rate of return on plan assets for 1988 and 1987 was 8.5%. Transition assets are being amortized over the greater of the remaining service period of active participants or 15 years.

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. The cost of providing postretirement health care and life insurance benefits is recorded on a cash basis. 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 years were as follows:

	1988	1987	1986
Total cost of health care and life insurance (in thousands)	$35,730	$32,133	$25,718
Number of active employees	13,049	13,560	13,307
Number of retirees	3,322	3,098	2,983

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 LP&L to refund the settlement proceeds to customers over the period 1983-93. Through December 31, 1988, LP&L had refunded a total of approximately $882 million to its customers.

In January 1987 and February 1988, a gas supplier submitted invoices to MP&L for approximately $24 million and $100 million, respectively, for amounts allegedly owed the supplier for MP&L's failure to take certain volumes of gas during 1986 and 1987 under a take-or-pay provision in a gas sales contract, which expired December 31, 1987. MP&L is of the opinion that it does not owe these amounts because the supplier was overcharging MP&L for gas deliveries during 1986 and 1987. Accordingly, in 1987, MP&L brought suit against the supplier seeking an adjudication and declaration of rights that it is not required to pay the supplier for any gas not actually received during 1986 and 1987 by MP&L, and that MP&L is excused from any obligation to take gas from the supplier so long as the supplier continues to overcharge MP&L for gas. This suit was amended by an order of the court on March 25, 1988, to include issues raised by the supplier's second invoice. On April 18, 1988, the supplier filed its amended answer and counterclaim for the amount of the 1987 and 1988 bills, plus interest, costs and attorney's fees. The time for discovery in this case ended on June 30, 1988. The MPSC has intervened in opposition to the supplier in this matter.

In the event that the court holds that the supplier did not overcharge MP&L during 1986 and 1987 and that a deficiency occurred in the amount of gas taken by MP&L during those years after all credits have been applied, it would be MP&L's intention to pay the supplier for the deficiency and ask the court to allow it to take the gas paid for during the year following any such final judicial ruling. In addition to the questions of whether MP&L was excused from its obligation to the supplier under the gas sales agreement in 1986 and 1987, and whether or not the supplier overcharged MP&L under the agreement, the court will address issues such as (1) the amount of any credits available to MP&L under the agreement, (2) the method of calculation, the timing, and the manner of any payment due to the supplier, and (3) the method of accounting for takes of gas after payment under the agreement. The matter is pending.

NOTE 12. QUARTERLY RESULTS (UNAUDITED)

Consolidated operating results for the four quarters of 1988 and 1987 were as follows:

Quarter Ended		Operating Revenues	Operating Income	Net Income	Earnings Per Share
		(In Thousands, except per share amounts)			
1988:					
	March	$ 786,907*	$258,394*	$ 92,167	$ 0.45
	June	$ 819,681	$249,790	$ 88,845	$ 0.43
	September	$1,095,335	$345,260	$171,755	$ 0.84
	December	$ 863,482	$216,125	$ 58,261	$ 0.29
1987**:					
	March	$ 769,650	$268,414	$100,707	$ 0.49
	June	$ 831,753	$258,753	$ 94,454	$ 0.46
	September	$1,075,049	$350,086	$186,391	$ 0.91
	December	$ 778,504	$132,803***	$ (24,948)***	$(0.12)***

** Restated to exclude gas operations of ANG, which was disposed of in June 1988.*
***Quarterly data for 1987 has not been restated for the disposition of ANG, as noted above. (See Note 1 – "Summary of Significant Accounting Policies.")*
****Includes the net effect of (1) the write-off of NOPSI's prudence disallowance of approximately $72.9 million, and (2) the discontinuance of LP&L's Waterford 3 rate deferrals of approximately $24.4 million.*

The business of the 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

	1988	1987	1986	1985	1984
	(In Thousands, except per share amounts)				
Net operating revenues	$ 3,565,405	$ 3,454,820	$ 3,485,912	$ 3,238,[illegible]59	$ 3,146,035
Net income	$ 411,028	$ 356,604	$ 454,465	$ 215,5[illegible]8	$ 508,437
Earnings per share	$ 2.01	$ 1.74	$ 2.22	$ 1.08	$ 2.86
Dividends declared per share	$ 0.20	–	–	$ 0.89	$ 1.75
Book value per share, year-end	$ 23.96	$ 22.13	$ 20.39	$ 18.19	$ 18.36
Total assets	$15,941,816	$15,156,832	$14,090,431	$13,390,015	$12,565,546
Long-term debt (excluding current maturities)	$ 6,187,442	$ 5,945,054	$ 5,983,029	$ 5,680,590	$ 5,865,304
Preferred stock with sinking fund	$ 462,965	$ 496,405	$ 508,165	$ 467,293	$ 476,928

DIRECTORS AND OFFICERS

Middle South Utilities, Inc.

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. Finance and Nuclear Committees.

W. Frank Blount
President, Network Operations Group, AT&T Company, Basking Ridge, New Jersey. Audit and Personnel Committees.

James B. Campbell*
Chairman of the Board and President of MISSCO Corporation, Jackson, Mississippi. Audit and Public Affairs Committees.

John A. Cooper Jr.
President of Cooper Communities, Inc., Bentonville, Arkansas. Finance and Nuclear Committees.

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

Kaneaster Hodges Jr.
Attorney, Newport, Arkansas. Audit (Chairman), Nuclear, and Public Affairs Committees.

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

James R. Nichols
Partner of Nichols & Pratt (Family Trustees) and Attorney, Boston, Massachusetts. Audit, Executive, and Finance (Chairman) Committees.

LeRoy P. Percy**
Cotton farmer; President of Greenville Compress Co., Greenville, Mississippi; Retired Chairman of the Boards of Mississippi Chemical Company and First Mississippi Corporation.

Robert D. Pugh
Chairman of the Board of Portland Gin Company (agricultural and agribusiness) and Portland Agri-Credit Corporation, Portland, Arkansas. Executive, Finance, and Personnel (Chairman) Committees.

H. Duke Shackelford
President of Shackelford Co., Inc., Shackelford Gin, Inc., and Louisiana Cotton Warehouse Co. Inc.; Chairman of Union Oil Mill, Inc. (all agricultural and agribusinesses), Bonita, Louisiana. Personnel and Public Affairs Committees.

Wm. Clifford Smith
President of T. Baker Smith & Son, Inc., Houma, Louisiana. Executive, Finance, and Nuclear (Chairman) Committees.

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

* *Elected to the Board of Directors at the May 20, 1988, Annual Meeting of Stockholders.*

** *Retired from the Board of Directors on May 20, 1988, at the Annual Meeting of Stockholders.*

MSU OFFICERS

Edwin Lupberger
Chairman and President. Age 52. Joined the Middle South Electric System in 1979. Sixteen years prior utility industry service.

James M. Cain
Senior Vice President, System Executive — Louisiana Division. Age 55. Joined the System in 1960.

William Cavanaugh III
Senior Vice President, System Executive — Nuclear. Age 50. Joined the System in 1969.

John L. Cowan
Senior Vice President, System Executive — Finance. Age 61. Joined the System in 1987.

Jerry D. Jackson
Senior Vice President, System Executive — Legal and External Affairs. Age 44. First joined the System in 1979.

Jack L. King
Senior Vice President, System Executive — Operations. Age 49. Joined the System in 1966.

Jerry L. Maulden
Senior Vice President, System Executive — Arkansas, Mississippi, and Missouri Division. Age 52. Joined the System in 1965.

Donald E. Meiners
Senior Vice President, System Executive — Services Division. Age 53. Joined the System in 1960.

H. Stuart Ball
Treasurer. Age 45. Joined the System in 1985.

Dan E. Stapp
Secretary. Age 54. Joined the System in 1958.

Dorothy M. Antoine
Assistant Secretary. Age 56. Joined the System in 1952.

Annual Meeting

The 1989 Annual Meeting of Stockholders will be held at 10 a.m. (CDT) on May 19, 1989, at the Natchez Eola Hotel, Natchez, Mississippi. A notice of the meeting and proxy material will be mailed on or about April 10, 1989, to stockholders of record as of the close of business on April 3, 1989. A badge for admission may be obtained at the registration desk at the meeting. 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 the Company's common stock as of April 3, 1989.

Dividends

At its September 30, 1988, meeting, the Board of Directors of Middle South Utilities, Inc. declared the first quarterly dividend in over three years. The dividend declared was 20 cents per share, payable on December 1, 1988, to stockholders of record as of November 9, 1988. On January 27, 1989, the Board of Directors declared a second quarterly dividend of 20 cents per share payable on March 1, 1989, to stockholders of record as of February 10, 1989.

Stockholders of Record

At the close of 1988, there were 88,346 stockholders of record of Middle South Utilities, Inc. A total of 204,581,092 shares were outstanding.

Stockholder Records

All correspondence concerning stockholder records should be directed to:

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

Transfer Agent and Registrar

Morgan Shareholder Services Trust Company is the transfer agent and registrar for MSU. 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, NY 10007-2192

Form 10-K

The Middle South Electric System 1988 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, LA 70161
(504) 529-5262

Financial and Statistical Review

Historical statistics and financial information supplemental to the 1988 Annual Report and Form 10-K are available in the Company's 1988 Financial and Statistical Review, which will be available for distribution in July. Copies of the Review may be obtained by contacting System Investor Relations at the address given in the next section.

Investor Relations

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

Middle South Utilities, Inc.
System Investor Relations
P.O. Box 61005
New Orleans, LA 70161
(504) 569-4365

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. Should stockholders approve the name change to Entergy Corporation, the ticker symbol and newspaper stock table listing would be ETR.

Composite Common Stock Prices by Quarters

	First	Second	Third	Fourth
1988 Price Range				
High-Low	$10 1/8-8 1/2	$14 1/8-8 5/8	$15 1/8-12 5/8	$16 1/8-14 7/8
1987 Price Range				
High-Low	$16 1/4-13	$14 5/8-10	$11 1/8-9 1/4	$11 5/8-7 3/4

For the past 40 years, the Middle South Electric System has been the leading electric energy supplier to the Middle South, a 91,000-square-mile regional area along the lower reaches of the Mississippi River.

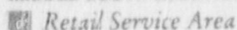
More than 1.6 million retail customers in Arkansas, Louisiana, Mississippi, and Missouri are provided electric services through the System's vast network of interconnected transmission and distribution lines, and a balanced grid of fossil fuel and nuclear generating plants that are controlled and operated as a unit.

In addition, electricity is sold wholesale to other utilities, including municipalities and cooperatives, and gas service is provided in New Orleans, Louisiana.

Headquartered in New Orleans, the Middle South Electric System includes four retail operating companies: Arkansas Power & Light (AP&L), Louisiana Power & Light (LP&L), Mississippi Power & Light (MP&L), and New Orleans Public Service Inc. (NOPSI); and a nuclear generating company, System Energy Resources, Inc. (System Energy), which is responsible for the management and operation of the Grand Gulf Nuclear Station. System Energy is currently seeking regulatory approval to assume operating responsibility, subject to AP&L and LP&L oversight, of the System's other three nuclear units.

Three additional subsidiary companies complete the System: MSU System Services, Inc. (SSI), which provides various technical, administrative, and corporate services to all of the System companies; System Fuels, Inc. (SFI), a fuels subsidiary; and Electec, Inc. (EI), a subsidiary that markets the commercial capabilities, expertise, and resources of the System companies.

MIDDLE SOUTH ELECTRIC SYSTEM

 *Retail Service Area*

The Middle South Electric System, through its subsidiary companies, provides electric service within the portions of Arkansas, Louisiana, Mississippi, and Missouri shown in red

Middle South Utilities, Inc.
P.O. Box 61006
New Orleans, LA 70161