ROCHESTER GAS and ELECTRIC CORPORATION

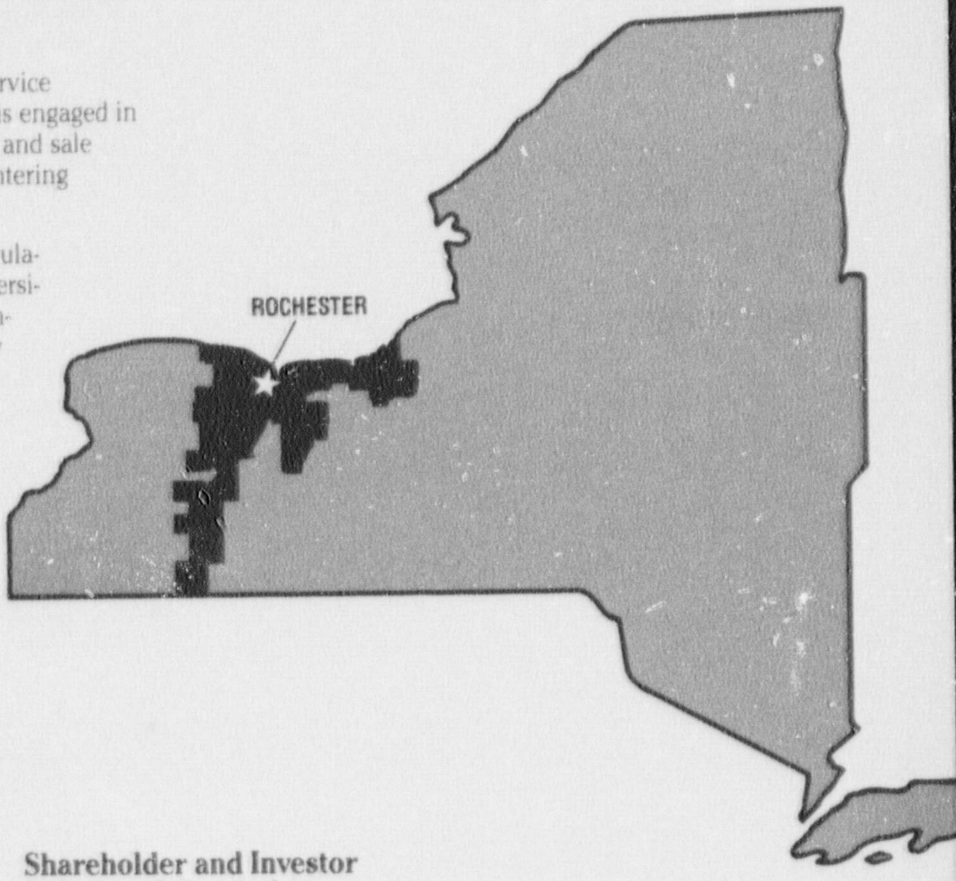
RGE
AND

1988 ANNUAL REPORT

RG&E Service Area/Business

The Company supplies electric and gas service wholly within the State of New York, and is engaged in the production, transmission, distribution and sale of these services in a nine-county area centering around the City of Rochester.

The Company's territory, which has a population of approximately 900,000, is well diversified among residential, commercial and industrial consumers. In addition to the City of Rochester, which is the third largest city and a major industrial center in the State, it includes a large and prosperous farming area.



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Our Cover

The color of our annual report cover this year duplicates the new color of our fleet vehicles. The old dark green is being replaced by "Doeskin Tan." Lighter colors provide added safety on the road.

The blue styled RG&E logo on our cover is also placed on the doors of the newly painted fleet vehicles.

Shareholder and Investor Relations Information

Inquiries regarding the Company's operations should be directed to David C. Heiligman, Vice President, Secretary and Treasurer of the Company.

Communications regarding changes of address, stock transfers, lost certificates or dividend payments should be directed to Chase Lincoln First Bank, N.A.

Corporate Office
89 East Avenue
Rochester, New York 14649
(716) 546-2700

Annual Meeting
May 17, 1989
At Rochester, New York

Listed
New York Stock Exchange
(Stock Symbol—RGS)

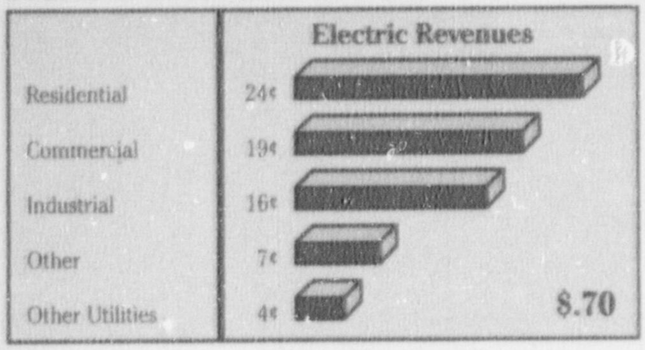
Transfer Agent and Registrar
Chase Lincoln First Bank, N.A.
Corporate Agency Department
Post Office Box 1250
Rochester, New York 14603
(716) 258-5874

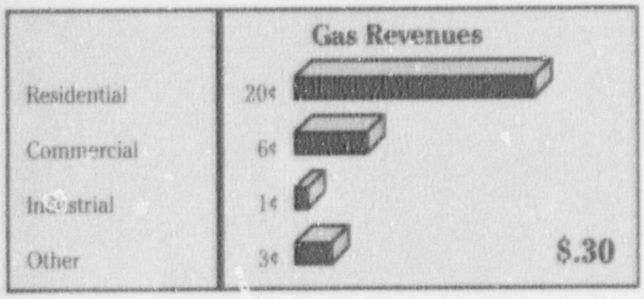
Agent for Automatic Dividend Reinvestment and Stock Purchase Plan
(See page 35 for description of plan)
Chase Lincoln First Bank, N.A.
Corporate Agency Department
Post Office Box 1507
Rochester, New York 14603
(716) 258-5854

First Mortgage Bond Trustee and Paying Agent
Bankers Trust Company
Attention: Security Holder Relations
Post Office Box 9006
Church Street Station
New York, New York 10249
(212) 250-6000

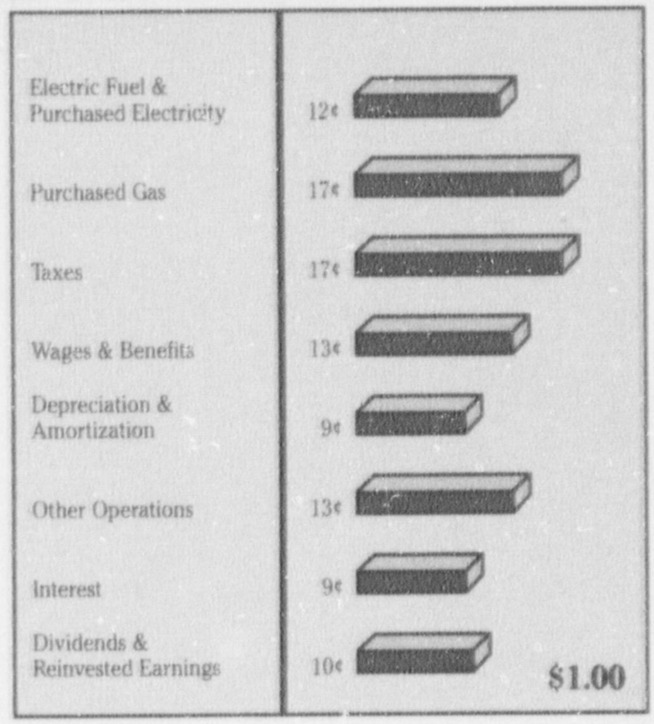
Form 10-K Annual Report
The Company will provide, without charge, a copy of the Annual Report on Form 10-K filed with the Securities and Exchange Commission with respect to fiscal year 1988, upon written request of any shareholder addressed to the Secretary.

Source of 1988 Revenue Dollar





Use of 1988 Revenue Dollar



Financial Highlights

Sales, Revenues and Earnings (Thousands, Except Per Share Amounts)	**1988**	1987	% Change
Electricity to customers			
Kilowatt-hours	**6,197,117**	5,948,763	4
Revenue	**$ 513,617**	$ 489,215	5
Electricity to other utilities			
Kilowatt-hours	**1,149,900**	1,047,654	10
Revenue	**$ 29,966**	$ 26,215	14
Gas			
Therms sold and transport	**483,766**	445,591	9
Revenue	**$ 230,395**	$ 216,058	7
Total operating revenues	**$ 773,978**	$ 731,488	6
Total operating expenses	**$ 635,104**	$ 609,113	4
Operating income	**$ 138,874**	$ 122,375	13
Nine Mile Two write-off, net	**—**	$ 262,000	—
Net income (loss)	**$ 76,114**	$ (168,711)	—
Earnings (loss) applicable to common stock	**$ 68,766**	$ (176,858)	—
Weighted average number of common stock shares outstanding	**30,513**	29,728	3
Earnings (loss) per common share	**$2.25**	$(5.95)	—
Cash dividends paid per common share	**$1.50**	$2.025	(26)
Rate of return on average common equity*	**12.68%**	12.45%	2
Book value per common share—year end	**$17.69**	$16.98	4
Utility Plant (Thousands)			
Capital expenditures, less allowance for funds used during construction	**$ 110,587**	$ 120,965	(9)
Net utility plant at December 31	**$1,510,090**	$1,474,746	2
Number of Customers at December 31			
Electric	**321,643**	317,033	1
Gas	**254,143**	250,124	2
Number of Common Stock Shareholders at December 31	**41,834**	44,127	(5)
Number of Employees at December 31	**2,600**	2,558	2

**Excludes disallowed Nine Mile Two costs written off in 1987.*

Letter to Shareholders

The Year 1988: For your Company, 1988 was a good year. Revenues, earnings per share and unit sales of electricity and gas all increased. Also, and perhaps more significant, the Nine Mile Two nuclear power plant was completed and went into commercial operation in the spring.

Nine Mile Two Completed: The plant's completion was a long-awaited event that culminated 13 years of RG&E involvement with a 14 percent share of ownership in the project. The delays in construction, periods of high interest and inflation rates, additional regulatory requirements and a series of technical problems made recent years the most difficult in our long corporate history.

The plant ran reasonably well during its initial period of operation. On October 1, the plant was taken out of service for scheduled maintenance and inspection. In December, senior managers of the U.S. Nuclear Regulatory Commission (NRC) conducted their nationwide biannual review of nuclear power plant performance. On December 20, the NRC advised Niagara Mohawk Power Corporation, operator of the plant, that they will be closely monitoring Nine Mile Two. Plants selected for close monitoring are those identified as having operational weaknesses that call for closer attention.

Niagara Mohawk Power Corporation is working to correct the problems and relieve the concerns raised by the NRC. Niagara advises that the outage will continue until mid-February 1989, delaying until late February the unit's return to full power.

Sales: We saw continued healthy growth in unit sales of electricity and gas in 1988. A prevailing strong economy in our service territory helped advance 1988 unit sales over the previous year's levels. Kilowatt-hour sales to customers for the year were up 4.2 percent. Therms of gas sold and transported rose 8.6 percent. In 1988 we added 4,600 electric customers and 4,000 gas customers. This was the 4th consecutive year in which customer growth maintained record levels.

Weather also favorably affected 1988 revenues and unit sales. A very hot summer brought heavy use of air conditioning equipment. On August 3, a new summer peak electric load record of 1,275,000 kilowatts was set. This was 5.8 percent above the previous summer peak reached in July of 1987.

Earnings: Improved revenues in 1988 provided a welcome gain in earnings. Per-share earnings of common stock for 1988 were $2.25 compared with $2.12 per share in 1987 excluding the effect of the Nine Mile Two write-off. Including a write-off of $262 million for disallowed Nine Mile Two costs, 1987 earnings showed a loss of $5.95 per share.

Retained Earnings and Dividends: In 1987, the Company wrote off $262 million as its share of the settlement agreement reached between the Nine Mile Two cotenants and the New York State Public Service Commission (PSC) (see Note 10 on page 28). That write-off forced us to reduce the annual common stock dividend from $2.20 a share to $1.50 a share.

We plan to rebuild retained earnings to a level at least equal to the annual dividend requirement for both common and preferred shares before considering any increase in the common stock dividend rate.

During 1988 we were able to rebuild retained earnings from $17.6 million at the beginning of the year to $39.7 million at year's end.

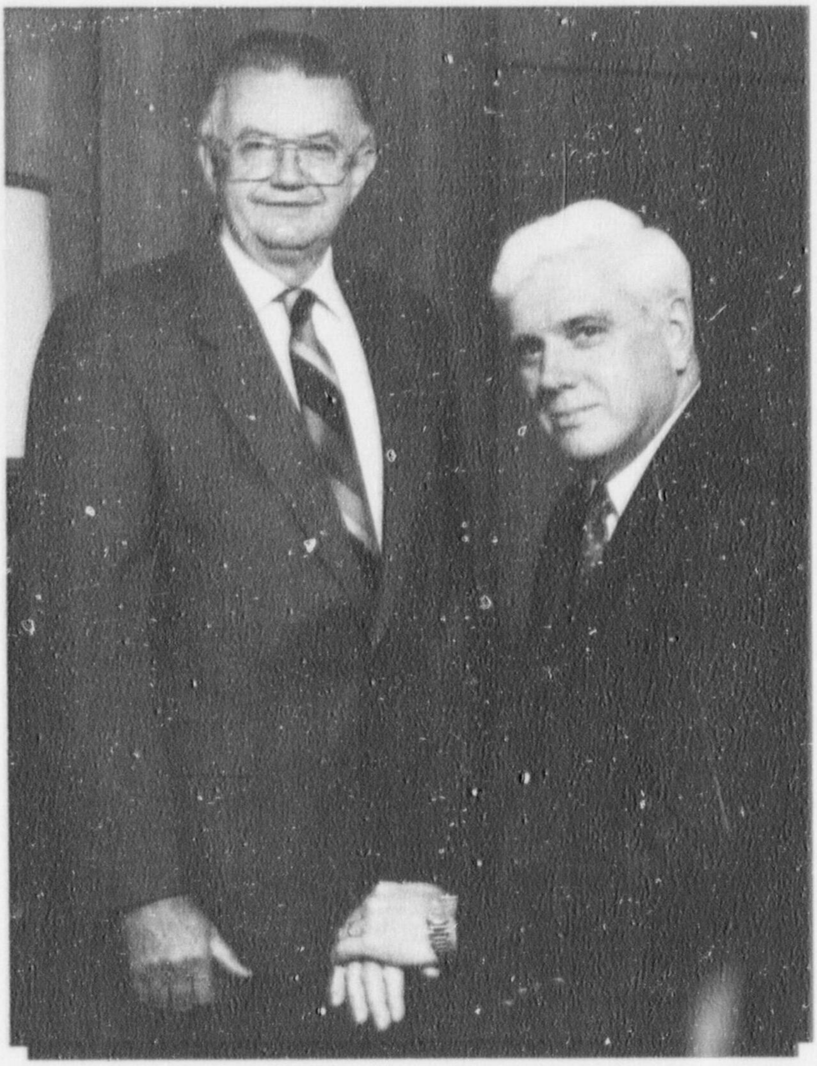
Electric Capacity: Our share of the Nine Mile Two capacity, or 151,000 kilowatts, gives us sufficient baseload capacity to meet expected electric demand well into the 90s. Also contributing to our capacity is our contract that allows us to continue buying inexpensive hydroelectric power from the New York Power Authority. The original contract was to have expired at the end of 1989. The new contract that extends hydropower purchases through the year 2007 provides continued benefits for our residential electric customers and helps keep RG&E competitive.

A good electric generation mix also keeps us competitive. We have a mix of coal, hydroelectric and nuclear generated electricity. More than half of our customers' electric requirement is supplied by nuclear power from our wholly owned and operated Ginna nuclear power plant and from our share of the Nine Mile Two plant. Nuclear fuel still holds a substantial cost advantage over alternatives, including coal.

The Ginna Plant: In 1988, the Ginna nuclear plant again had an excellent operating record. The plant was available 86 percent of the time. That's a high rating compared with the national average for nuclear power plant availability as is the plant's 85 percent capacity factor for the year. Capacity factor is a measure of how much of the plant's potential production was achieved.

Rate Stabilization: In 1988, RG&E reached an agreement with the PSC that the Company will not ask to raise electric or gas rates to be effective before July 1, 1990. This agreement will have kept the base rates for electricity and gas unchanged for at least two and a half years, stabilizing rates for our customers and helping to promote business expansion in our nine-county service territory.

Capital Requirements: With the completion of the Nine Mile Two plant, our capital needs have been reduced from previous years. We are in a position to finance



Harry G. Saddock (l) and Roger W. Kober

most of our capital requirements from internal sources. We did, however, take advantage of a tax-exempt bond issue last December that provided $25.5 million at an eight and three-eighths percent interest rate.

Diversification: We made our first entry into a diversified, wholly owned subsidiary in 1988 when we created a company called Utilicom. This venture, with a modest capitalization of $1 million, is creating and marketing computerized interactive video training software for use in commerce and industry. The company also produces software that makes environmental regulatory compliance record keeping much simpler.

While the Company may consider other diversification opportunities, the Utilicom venture is the only such diversification we plan for the time being. We intend to stay close to our primary business—energy production, service and sales.

Leadership Recognized: We want to recognize the valuable contributions in corporate leadership made by former Chairman of the Board and Chief Executive Officer Paul W. Briggs and former Vice Chairman of the Board Keith W. Amish. Paul retired on December 1 after 43 years of service, and, after 41 years at RG&E, Keith retired on September 1. Each guided the Company through the difficult Nine Mile Two period, and each agreed to postpone regular retirement to see the Company through to the commercial operation of the plant. With their guidance the Company weathered the difficult financial and regulatory years created by the Nine Mile Two project. All of us, employees, shareholders and customers owe Paul and Keith a great deal.

The Outlook—Becoming the Best: We expect to see more competition as deregulation of energy markets intensifies. Deregulation will bring about profound changes for us and our customers. While we can't now predict when, how and who will benefit from the changes, we are convinced there is only one strategy that can be successful in the competitive arena—become the best.

Becoming the best is a consensus reached by your senior management. We've spent a good deal of time identifying specific goals for the future, and pinning down our corporate mission.

Our mission is to be the preeminent private utility in New York State operating as an effective supplier of energy and related services by optimizing customer satisfaction, investor return and employee achievement.

We set several identifiable five-year goals.

- Increase customer satisfaction
- Promote employee and public safety
- Optimize employee achievement
- Attain decreases in the real cost of our products
- Earn the allowable return on equity
- Increase sales margins
- Develop flexible price structures to recognize competition
- Implement innovative use of assets
- Develop conservative diversification projects

We believe we are on the right track. We have our mission before us with specific goals to achieve. The Nine Mile Two project is completed. A rate freeze, continuing cost control measures, fine productivity from our dedicated employees, a new consumer program known as Customer Connection and an aggressive marketing effort combine to move us into a strong tomorrow.

We are optimistic at RG&E. There are new challenges ahead in this business. We believe we have the talent, people and drive to make the challenges work for us, our customers, and for you, the shareholders. We will become the best.

Harry G. Saddock

Harry G. Saddock
Chairman of the Board
and Chief Executive
Officer

Roger W. Kober

Roger W. Kober
President
and Chief Operating
Officer

February 3, 1989

Management Appointments

Clockwise from upper left: Robert E. Smith, Wilfred J. Schrouder, Jr., David C. Heiligman, and Howard E. Rowley.

On June 15, 1988, the board of directors elected Harry G. Saddock as chairman of the board and chief executive officer and Roger W. Kober as president and chief operating officer. Those appointments became effective upon the retirement of former Chairman of the Board and Chief Executive Officer Paul W. Briggs on December 1, 1988. Former Vice Chairman of the Board Keith W. Amish retired on September 1, 1988.

In other appointments, David C. Heiligman was named vice president, secretary and treasurer of the corporation.

Howard E. Rowley was appointed vice president, gas and transportation.

Wilfred J. Schrouder, Jr. became vice president, employee relations and public affairs.

Robert E. Smith was appointed vice president, production and engineering.

Board Appointments

M. Richard Rose

Roger W. Kober

At the 1988 annual meeting of shareholders in May, M. Richard Rose, Ph.D. was elected to the board of directors. He is president of the Rochester Institute of Technology (RIT), a position he has held since 1979. Dr. Rose replaced Paul A. Miller, president emeritus and professor at RIT, who retired from the board after 14 years of service as a director.

President and Chief Operating Officer Roger W. Kober was elected to the board of directors effective December 1, 1988.

The following is Management's assessment of significant factors which have affected the Company's financial condition and operating results. As indicated below, the Company's participation in the Nine Mile Two project has had and will continue to have a substantial impact on its financial condition and earnings. In the spring of 1988, Nine Mile Two entered commercial operation marking the completion of the construction and pre-operational testing phases of the project.

Nine Mile Two

The Company owns a 14 percent share of the Nine Mile Two facility, a 1,080,000 kilowatt nuclear generating unit that was constructed and is being operated by Niagara Mohawk Power Corporation (Niagara) near Oswego, New York. The Company's primary capital commitment over the past several years has been for the construction of this facility and, in the spring of 1988, construction was completed and the unit entered commercial service. Niagara is operating the unit on behalf of all owner cotenants pursuant to a full power operating license which the Nuclear Regulatory Commission (NRC) issued on July 2, 1987 for a 40-year term beginning October 31, 1986. The NRC in December 1988 added Nine Mile Two to its list of nuclear plants which require "close monitoring" by it, a category of plants identified as having weaknesses warranting such attention. The NRC's action came during an outage of Nine Mile Two for repairs and planned maintenance. Niagara has advised the Company that the outage will continue until mid-February 1989, delaying until late February the unit's return to full power.

In October 1986, the New York State Public Service Commission (PSC) issued an order approving a settlement proposal (Nine Mile Two Settlement) which limits to $582 million (less prepaid financing charges currently estimated at $96 million) the amount of Nine Mile Two construction costs which may be included in the Company's rate base. As a result of a rate agreement approved by the PSC in July 1988, the Company's full investment in allowable Nine Mile Two capital costs, assuming an April 15, 1988 commercial operation date, has now been included in rate base for the rate year beginning August 1, 1988.

The PSC has fixed April 5, 1988 as the Nine Mile Two commercial operation date for Niagara and Long Island Lighting Company, two of the project's five cotenants. The PSC has not yet taken formal action on the subject with respect to the rates and accounts of the Company. The Company's 1988 rate case settlement utilized a hypothetical date of April 15, 1988 for commercial operation of Nine Mile Two, but contemplated that an actual commercial operation date might be separately adopted. The Company believes it likely that the PSC will ultimately select April 5, 1988, as the appropriate commercial operation date for the Company.

In 1987, the Company wrote off $262 million (net of tax) of its investment in Nine Mile Two (see Rate Base, Accounting Change and Regulatory Policies) in recognition of the Nine Mile Two Settlement. The Company will recognize any adjustment in that amount necessary to conform to the PSC recognized commercial operation date. A change from the May 15, 1988 commercial operation date assumed by the Company in the 1987 write-off will result in additional income or loss of approximately $6 million (net of tax) per month. PSC confirmation of the commercial operation date as of April 5, 1988, would diminish the Company's loss. However, as presented in Note 10 of the Notes to Financial Statements, resolution of certain items currently being disputed with the PSC could result in other adjustments to the loss recognized by the Company. The Company is unable to determine at this time the adjustment necessary, if any, to recognize the resolution of these outstanding issues with respect to the Nine Mile Two Settlement.

In September 1988 the Company received $40.6 million from Niagara as part of the Nine Mile Two Settlement. This reimbursement had been recognized in 1987 in determining the $262 million Nine Mile Two write-off described above. Refer to Note 10 of the Notes to Financial Statements for additional information regarding the Company's investment in Nine Mile Two.

Liquidity and Capital Resources

The combination of $40.6 million in cash received from Niagara as discussed above, lower construction expenditures, additional refunding of higher cost securities, and the full-year effect of the 1987 rate increase improved the Company's cash flow in 1988.

Capital Requirements

The Company's capital requirements for the three-year period 1986–1988 and the current estimate of capital requirements through 1991 are summarized in the table on page 7.

For the period 1989 to 1991, the Company anticipates construction requirements to average approximately $120 million per year. In addition to its construction expenditures, the Company has mandatory securities maturities and sinking fund obligations, which total approximately $100 million over the next three years through 1991.

Included in the table on page 7 are the carrying charges, or financing costs, associated with major projects under construction. These carrying costs become a part of the capitalized cost of the related project. The Company begins to earn a cash return on its investment, including these carrying costs, when the cost of the project is included in rate base, which generally is at the time such project is

Capital Requirements

Type of Facilities	Actual 1986	Actual 1987	Actual 1988	Projected 1989	Projected 1990	Projected 1991
	(Millions of Dollars)					
Electric Property:						
Production	$101	$ 60	$ 39	$ 46	$ 32	$ 26
Transmission and Distribution	25	22	28	24	34	32
Street Lighting and Other	2	2	1	3	3	2
Subtotal	128	84	68	73	69	60
Nuclear Fuel	12	16	17	19	17	20
Total Electric	140	100	85	92	86	80
Gas Property	13	14	15	16	15	15
Common Property	7	7	7	11	13	14
Total	160	121	107	119	114	109
Carrying Costs:						
Allowance for Funds Used During Construction (AFUDC)	45	8	4	4	6	5
Deferred Financing Charges Included in Other Income	5	6	1	2	2	—
Total Construction Requirements	210	135	112	125	122	114
Securities Redemptions, Maturities and Sinking Fund Obligations*	55	91	69	35	25	40
Total Capital Requirements	$265	$226	$181	$160	$147	$154

**Excludes prospective refinancings.*
Note: AFUDC in 1986 has not been restated to reflect the disallowance of certain Nine Mile Two plant costs recognized by the Company in 1987.

put into service. Certain Nine Mile Two plant construction costs, however, were included in rate base prior to commercial operation. This action, while reducing the amount of AFUDC, enhanced the Company's cash flow at such time. With the full recognition of allowable Nine Mile Two plant construction costs now in rate base (see Rate Base, Accounting Change and Regulatory Policies) and construction projects of a shorter duration than Nine Mile Two, the Company expects the level of AFUDC to stabilize in the $4 million to $6 million range for the next several years. In addition to AFUDC, carrying charges include the recognition of certain customer prepaid financing costs discussed below under Rate Base, Accounting Change and Regulatory Policies.

1988 Capital Requirements. With the completion and commercial operation of Nine Mile Two, construction expenditures for the year dropped to $112 million, well below the average for the prior two years. Electric production plant requirements for 1988 included $17 million of expenditures made at the Company's Ginna nuclear plant and $16 million of expenditures for Nine Mile Two, including $3 million for post-in-service projects. The Company also invested $26 million to upgrade electric distribution facilities to maintain customer service standards for both existing and new customers. In addition, the Company spent $17 million for nuclear fuel, largely at the Ginna nuclear plant.

In the Gas Department, the replacement of older gas services, the relocation of gas mains for highway improvement, and the installation of gas services for new load resulted in construction expenditures of $16 million, including AFUDC, in 1988.

Total capital requirements in 1988 also included mandatory sinking fund obligations totaling approximately $3.6 million. As discussed under Liquidity, Financing and Capital Structure, the Company was also able to lower its cost of capital in 1988 by redeeming approximately $60 million of high-cost senior securities.

Projected Capital Requirements. With no specific plans for major additions to generating capacity, the Company expects to carry out a program to extend the operating life of existing generating units and to make ongoing modifications to the Ginna nuclear plant and Nine Mile Two. In addition, the Company's construction program will focus on the need to serve new customers, to provide for the replacement of obsolete or inefficient utility property and to modify facilities consistent with the most current environmental and safety regulations. The projected 1989 construction requirements reflect primarily additional expenditures at the Ginna nuclear plant associated with its second mandatory ten-year in-service inspection in 1989, plant modifications to comply with recent NRC directives and overall efforts to maintain the high standards of performance the Company has set for the plant.

In addition to its projected construction requirements, the Company also has future maturities and sinking fund obligations as indicated in the table above and may consider, as conditions warrant, the redemption or refinancing of certain long-term securities.

The Company's capital expenditures program is under continuous review and will be revised depending upon the progress of major construction projects, customer demand for energy, rate relief, government mandates and other factors.

Liquidity, Financing and Capital Structure

During 1988, lower construction requirements, compared with prior years, improved cash flow and limited the need to obtain external financing. Internally generated funds were sufficient to fund the Company's capital requirements for the year. Notwithstanding the Company's strong cash position, new common stock shares were issued through the ongoing Automatic Dividend Reinvestment and Stock Purchase Plan (ADR Plan) which improved common equity capitalization. In addition, the Company obtained low-cost tax-exempt financing with the issuance of a new series of first mortgage bonds in connection with a Nine Mile Two pollution control financing. A strong cash position enabled the Company to retire certain high-cost senior capital obligations without having to refinance such redemptions. Such refundings contributed to a drop in the Company's embedded cost of debt from 8.90% at the end of 1987 to 8.71% at year-end 1988. Likewise, the Company's embedded cost of preferred stock was 6.72% at the end of 1988 compared with 7.09% a year earlier.

With construction activity as presently projected and the Company's current cash position, the Company anticipates it will not require additional long-term financing to meet its capital requirements for the next several years. Should capital requirements exceed current estimates and create the need for external financing, the Company anticipates utilizing its revolving credit agreement. Certain of the Company's financial agreements contain covenants which may restrict the Company's ability to incur additional indebtedness if the need for external financing is beyond that provided by the Company's revolving credit agreement.

Financing. Interim financing is available through short-term borrowings with bank notes and commercial paper. To replace an expiring revolving credit agreement, a new agreement totaling $90 million and effective December 1, 1988 was negotiated by the Company with certain domestic banks. Certain restrictive covenants contained in the Company's prior revolving credit agreement and relating to Nine Mile Two were removed in the new agreement, thereby enabling the Company to obtain greater short-term financing flexibility. The new revolving credit agreement expires December 1, 1991, but may be extended annually for a successive three-year period. At December 31, 1988, the Company had no short-term debt outstanding.

The Company's Certificate of Incorporation (Charter) provides that unsecured debt may not exceed 15 percent of the Company's total capitalization (excluding unsecured debt) without the approval of at least a majority of the holders of outstanding preferred stock. As of December 31, 1988, the Company would be able to incur approximately $6 million of unsecured debt under this provision before needing to obtain the required approval as indicated. In order to be able to use its revolving credit agreement, the Company has created a subordinate mortgage which secures borrowings under its revolving credit agreement that might otherwise be restricted by this provision of the Company's Charter.

As part of the Company's continuing program to improve its capital structure and reduce its embedded cost of capital, two security issues were redeemed in 1988. On November 1, 1988, $40 million of First Mortgage 11¾% Bonds, Series NN, were redeemed at a redemption price of 105.22 percent of the principal amount; and on December 1, 1988, 183,108 outstanding shares of 8.60% Preferred Stock, Series P, were redeemed at the redemption price of $105 per share. Payment for these redemption transactions was provided out of cash and temporary cash investments. The December redemption of Series P Preferred Stock followed an open-market purchase and sinking fund redemption earlier in the year, which totaled approximately 33,000 shares, thereby eliminating all outstanding shares of Series P stock.

In December 1988, the Company issued $25.5 million of First Mortgage 8⅜% Bonds, Series OO, to secure an equal amount of tax-exempt pollution control revenue bonds issued by the New York State Energy Research and Development Authority. Proceeds from this financing were used to reimburse the Company for prior expenditures associated with the Company's share of certain pollution control facilities at Nine Mile Two.

The Company in 1988 raised a total of $10.4 million to finance its capital expenditures program by issuing approximately 619,000 shares of common stock through its ADR Plan. To meet the demands of its construction program and to maintain a prudent capital structure, the Company over the past three years has issued common stock at a market price below the book value per share. Such sales have had a dilutive effect on the book value per share at the time of issuance. The Company's book value per share did increase, however, during 1988. Book value per share at December 31, 1988 was $17.69. Per-share book value of $16.98 at December 31, 1987 was significantly lower than the $24.93 book value per share a year earlier and reflects the net Nine Mile Two write-off in 1987 of $262 million ($8.81 per share).

Capital Structure. The Company's retained earnings at December 31, 1988 were $39.7 million, up approximately $22 million compared with a year earlier. Approximately 38.0 percent of the Company's capitalization at December 31, 1988 was comprised of common equity (including retained earnings), with the balance being comprised of 6.7 percent preferred equity and 55.3 percent long-term debt. These percentages are based on the Company's capitalization exclusive of its long-term liability to the Federal Department of Energy (see Note 1 of the Notes to Financial Statements). The Company's retained earnings reflect a $262 million write-off in 1987 for disallowed Nine Mile Two plant costs as discussed below under the heading Rate Base, Accounting Change and Regulatory Policies. Upon resolution of certain regulatory issues associated with the Nine Mile Two plant, adjustments may be required which could increase or decrease the Company's retained earnings as discussed in Note 10 of the Notes to Financial Statements. It is the Company's intention to move to a less leveraged capital structure through growth in retained earnings and the retirement of long-term debt through mandatory sinking fund redemptions and maturities. To improve its capital structure, the Company will also consider the optional redemption of high-cost senior securities.

Rate Increases

Granted

Class of Service	Effective Date of Increase	Amount of Increase (Decrease) (Annual Basis) (000's)	Percent Increase (Decrease)	Authorized Rate of Return on Rate Base	Authorized Rate of Return on Equity
Electric	February 1, 1985	$ 4,535*	0.9%	12.52%	16.00%
	July 14, 1985	5,799	1.3	12.09	15.00
	January 2, 1986	2,845*	0.6	12.09	15.00
	July 20, 1986	20,895	4.4	10.75	12.60
	January 2, 1987	1,223*	0.2	10.75	12.60
	July 17, 1987	16,198	3.4	10.48	13.20
	January 4, 1988	2,413*	0.5	10.48	13.20
	July 26, 1988	—	—	10.39**	13.40
Gas	July 14, 1985	157	0.1	12.09	15.00
	July 20, 1986	(3,185)	(1.1)	10.75	12.60
	January 2, 1987	458*	0.2	10.75	12.60
	July 17, 1987	—	—	10.48	13.20
	July 26, 1988	—	—	10.39**	13.40

*Second step increase allowed.

**For the year beginning August 1, 1989, the authorized rate of return on rate base is 10.46%.

Rate Base, Accounting Change and Regulatory Policies

In June 1988, the Company, PSC staff, the New York State Consumer Protection Board and other intervening parties to the Company's pending rate case, negotiated a rate settlement (the 1988 Rate Agreement) which was approved by the PSC one month later. The 1988 Rate Agreement freezes the Company's base rates for electric and gas service at their present levels through at least June 1990. As part of the 1988 Rate Agreement, the Company was permitted to include the balance of allowable Nine Mile Two capital costs in rate base beginning August 1988. A summary of recent PSC rate decisions is presented in the table to the upper right.

Accounting Change. The Company's accounting policies conform to generally accepted accounting principles as prescribed by the Financial Accounting Standards Board (FASB) and applied to New York State utilities giving effect to the rate-making and accounting policies of the PSC. In September 1987 the Company adopted revised financial accounting principles prescribed by the FASB for disallowed plant costs (Statement of Financial Accounting Standards No. 90) and recognized for financial accounting purposes an aggregate $262 million after-tax write-off of disallowed Nine Mile Two plant costs based on a 1986 settlement agreement, discussed below, with the PSC.

The 1987 net of tax write-off includes the cumulative effect on retained earnings as of January 1, 1987 of $193 million, the reversal of $22 million of AFUDC recognized during the year and an additional $47 million to reflect other costs recognized during 1987. The Company reflected the cumulative effect of the accounting change of $193 million in its Statement of Income rather than restating previously issued financial statements. Accordingly, the net disallowance was presented separately for the effect prior to January 1, 1987, and for portion of the disallowance which became known during 1987. No amounts of disallowed costs were recognized in 1988. The ultimate amount of disallowed Nine Mile Two costs to be recognized by the Company cannot presently be determined because of the uncertainties associated with the implementation of the Nine Mile Two Settlement, as previously discussed.

New York State Public Service Commission (PSC). The October 1986 PSC order approving the Nine Mile Two Settlement limits to $582 million (less prepaid financing charges) the amount of Nine Mile Two plant construction costs which may be included in the Company's rate base. The Nine Mile Two Settlement, which is under judicial challenge, resolved a proceeding established by the PSC in July 1985 to investigate the prudence of costs relating to the construction of Nine Mile Two. To implement the Nine Mile Two Settlement, the PSC for rate-making purposes reduced the Company's equity component of total capitalization, used to calculate the Company's cost of capital, effective August 1987. This action, which assumed a commercial operation date of February 15, 1988, effectively reduced future revenues by reducing the base on which future rates would be calculated.

As mentioned above, the 1988 Rate Settlement permits the Company to include its allowable Nine Mile Two capital costs in rate base beginning August 1, 1988. Also, essentially all operating and maintenance expenses for plant operation are reflected in rates. Other major provisions of the 1988 Rate Settlement include:

- Agreement by the Company to no changes in electric and gas base rates through at least June 1990.
- An equal sharing between customers and shareholders of any earnings above the authorized return on common equity of 13.4%.
- Authority to include in income $42 million in unbilled revenues and $5 million in deferred Nine Mile Two revenues over the two-year period ending July 31, 1990. (See Operating Revenues and Sales.)
- Permission to eliminate by offset one-half of the deferred debit and credit balances in connection with the unused portion of customer prepaid financing costs associated with Nine Mile Two (see following paragraph).

Rate decisions prior to the 1988 Rate Settlement had allowed the Company to include up to $430 million of Nine Mile Two plant costs in rate base. This action had enhanced the Company's cash flow and reduced the amount of AFUDC because AFUDC was not accrued on those amounts included in rate base. A comparable amount, however, calculated similarly to AFUDC and representing customer prepaid financing costs, was calculated up to commercial operation and recorded on the Balance Sheet as a liability, shown as a deferred credit. An equivalent amount was recorded as a deferred asset on the Company's Balance Sheet, since it represents deferred financing costs (or AFUDC) which are expected to be recovered over the life of the facility through amortization, if the PSC chooses to utilize these amounts to moderate customer rates. As permitted by the 1988 Rate Settlement, the Company in July 1988 eliminated one-half of these deferred balances by offset (that is, equal amounts of both the deferred debit and deferred credit balances were eliminated), and the remainder, estimated at approximately $45 million, will be eliminated by July 31, 1992 if not used prior thereto as non-cash earnings for rate moderation purposes. The 1988 Rate Agreement allows the Company to amortize $4.1 million of the $44.7 million deferred credit balance to Other Income for the rate year ending July 31, 1990, with a corresponding increase to the Company's rate base. Amortization of these deferred credits totaled $10.9 million through December 31, 1988.

Under the 1988 Rate Agreement, the Company agreed to exclude from rate base certain post-in-service Nine Mile Two capital additions pending review of such expenditures by the PSC. The PSC has allowed the Company to accrue carrying charges (AFUDC) on these expenditures until final consideration for inclusion in rate base is made. The 1988 Rate Agreement contemplated a separate proceeding late in 1988 to examine these amounts, currently estimated at $13 million. The Company is unable to predict what position the PSC will ultimately adopt or what adjustments to the Company's capitalization will be required.

In May 1988 the PSC ordered that take-or-pay (TOP) charges from gas pipeline suppliers should be deferred by the Company and other New York State gas distribution companies until the PSC determines if the gas distribution companies should be required to absorb any portion of the TOP charges. In October 1988 the PSC appeared to have concluded that it could deny recovery of TOP costs billed by an interstate pipeline supplier and paid by a gas distribution company. The Company has sought rehearing of that apparent conclusion but, as of mid-January 1989, the Company had not received a response from the PSC. The PSC has scheduled hearings to determine whether gas distribution companies should be required to absorb some portion of such TOP costs and how that portion recoverable from customers should be allocated among them. Staff of the PSC and the Company have entered into an interim settlement which would permit the Company to recover from customers 65% of the TOP costs during the continuation of the PSC proceeding but other parties to the proceeding oppose this interim settlement and the PSC had not acted on it as of mid-January 1989. At December 31, 1988 the Company had deferred $1.1 million of billed TOP charges. The Company is unable to estimate either the amount which may ultimately be included in its pipeline suppliers' charges to it for TOP charges, or the amount which it will be allowed to recover from customers.

Results of Operations

The following financial review identifies the causes of significant changes in the amounts of revenues and expenses, comparing 1988 to 1987 and 1987 to 1986. The Notes to Financial Statements on pages 19 to 34 of this report contain additional information. Upon the commercial operation of Nine Mile Two, recognized by the Company in April 1988, the Company began to record operating revenues and operating expenses associated with the plant's operation.

Operating Revenues and Sales

Compared with the prior year, operating revenues increased six percent in 1988 after declining two percent in

Operating Revenues

Increase or (Decrease) from Prior Year

(Thousands of Dollars)	Electric Department **1988**	1987	Gas Department **1988**	1987
Customer Revenues (Estimated) from:				
Rate Increases	**$ 12,029**	$ 19,924	**$ (37)**	$ (1,499)
Unbilled Revenues	**7,198**	—	**1,330**	—
Fuel Clause Adjustments	**(19,378)**	(11,841)	**(2,152)**	(18,865)
Weather Effects (Heating)	**660**	(559)	**9,187**	(8,551)
Customer Consumption	**15,205**	11,340	**11,672**	(2,654)
Transportation Gas	**—**	—	**(6,174)**	(16,442)
Other	**8,688**	3,855	**511**	2,381
Total Change in Customer Revenues	**24,402**	22,719	**14,337**	(45,630)
Electric Sales to Other Utilities	**3,751**	5,750	**—**	—
Total Change in Operating Revenues	**$ 28,153**	$ 28,469	**$ 14,337**	$ (45,630)

1987. Details of the revenue changes are presented in the table above. Operating revenues less fuel expenses were also up in 1988 as shown in the graph to the right.

Electric revenues derived from rate increases, as presented in the table above, include approximately $8.1 million in 1988 and $13.7 million in 1987 which represent the Nine Mile Two in-service revenue requirements estimated in the Company's rate proceedings. Since commercial operation of Nine Mile Two was delayed beyond the date assumed in those rate orders, these revenues were deferred through a debit (charge) to operating expenses and, therefore, did not affect earnings. With the commercial operation of Nine Mile Two, the Company began to reverse these deferrals, as discussed under the heading Operating Expenses, Excluding Fuel.

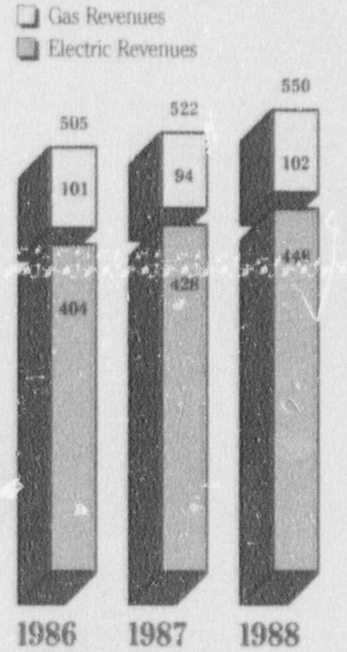
Beginning in July 1988 as part of a rate decision, the PSC approved recording of unbilled revenue. Accordingly, approximately $42 million associated with the change in accounting will be amortized to income during the period July 1988 to July 1990. Unbilled revenues represent revenues for energy delivered to customers, but not yet recorded as income. As a non-cash item, such revenues do not enhance the Company's cash position. The Company has recorded unbilled accounts receivable of $45.9 million as of December 31, 1988. In accordance with the 1988 Rate Agreement, $8.5 million of unbilled revenue was recognized in the Company's 1988 Statement of Income. The deferred credit balance ($39.8 million at December 31, 1988) will be amortized monthly to revenues in accordance with PSC rate decisions. Under the 1988 Rate Agreement, the Company will amortize to revenues $20.6 million of these deferred unbilled revenues in 1989. Recognition of unbilled revenue will affect the Company's normal seasonal earnings pattern beginning in 1989, since the recognition of revenues, primarily for the Gas Department, will occur in different months than in the past. Accordingly, beginning with 1989, fourth quarter earnings will be higher and first quarter earnings will be lower than in prior years.

The Company's fuel clause provisions provide that customers and shareholders will share, generally on an 80%/20% basis, respectively, the risks or benefits derived from variations in electric fuel costs, generation mix and sales of electricity to other utilities compared with forecasted amounts as established by the PSC. As a result of these sharing arrangements, discussed further in Note 1 of the Notes to Financial Statements, pretax earnings were reduced $1.1 million in 1988 primarily reflecting the variance between actual fuel costs and generation mix compared with rate assumptions. Earnings in 1987 were enhanced by $9.7 million on a pretax basis related to these sharing arrangements, primarily attributable to provisions effective prior to August 1987 associated with electric sales to other utilities.

The effect of weather variations on operating revenues is most measurable in the Gas Department, where revenues from space heating customers comprise about 90 percent of total gas operating revenues. Measured on a customer billing degree day basis, the weather as related to heating in 1988 was approximately seven percent colder than 1987. Conversely, weather for all of 1987 was four and one-half percent warmer

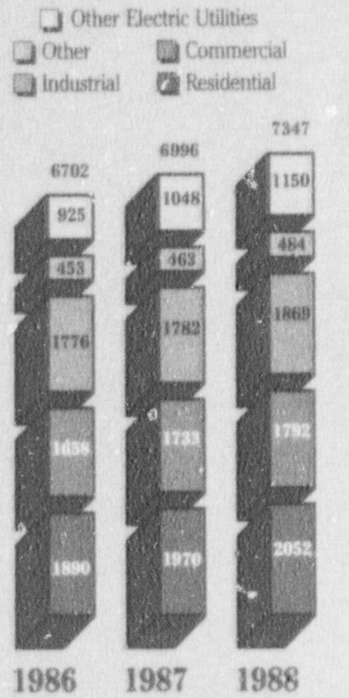
Operating Revenues less Fuel Expenses

(Millions of Dollars)



Both electric and gas revenues in 1988 showed increases compared with 1987.

Electric Market Profile
(Thousands of Megawatt-hours Sold)



Electric energy sales reflect a well-balanced sales mix.

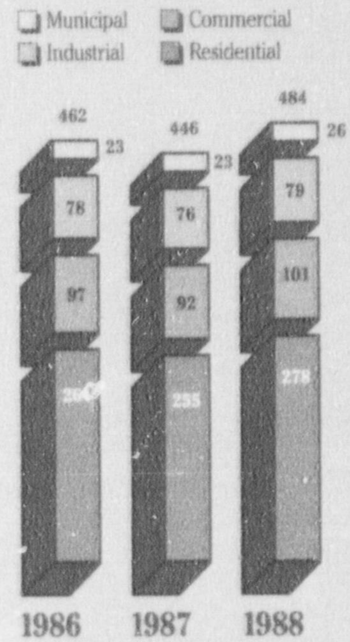
than 1986 on a customer billing degree day basis.

As illustrated by the graph above, the sale of electric energy is well diversified among all major customer classes and a strong local economy resulted in an increase of electric sales to all major customer groups in 1988 and 1987. Unusually warm weather during the summer months of 1987, followed with even warmer weather during the 1988 summer months, resulted in an increased use of air conditioning during both comparison periods. In addition, the continued strong growth in the number of electric customers contributed to increased sales of electricity in 1988 and 1987. In August 1988, the Company experienced a new record demand of 1,275 megawatts on its electric system, or 5.8 percent above the previous record peak demand set in 1987.

Fluctuations in revenues from electric sales to other utilities are generally related to the Company's customer energy requirements, New York Power Pool energy market conditions and the availability of electric generation from the Company's nuclear-fueled plants, including its share of Nine Mile Two. The availability of power from Nine Mile Two, along with generation from the Ginna nuclear plant, allows the Company to sell more fossil-fueled generation to other utilities while retaining lower-cost nuclear-generated energy for the Company's own electric customers.

Since October 1985 the Company has transported gas for certain large commercial and industrial customers (and, more recently, certain large municipal customers) who are able to purchase natural gas directly from producers and use the Company's facilities to transport it. Gas supplies transported in this manner, which amounted to 83.6 million therms in 1988 and 67.5 million therms in 1987, are not included in Company therm sales. These purchases cause decreases in customer revenues, as shown in the table on page 11, with offsetting decreases in fuel expenses, but do not adversely affect earnings because these customers are billed at rates which, except for the cost of gas, approximate the rates charged the Company's other gas service customers.

Gas Market Profile
(Millions of Therms Sold and Transported)



Gas energy sales are well balanced between residential and non-residential customers.

Total therms sold and transported increased in 1988 by 8.6 percent after decreasing 3.5 percent in 1987, as presented in the graph above. These fluctuations reflect the effect of weather variations, as previously discussed, primarily on therm sales to residential customers with gas space heating. In 1988, an increase in

Operating Expenses

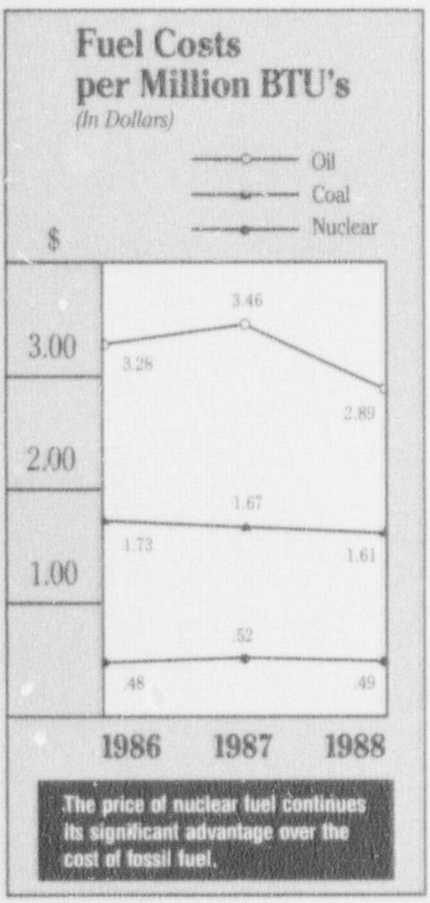
Increase or (Decrease) from Prior Year
(Thousands of Dollars)

	1988	1987
Fuel for Electric Generation	**$ 4,344**	$ 11,912
Purchased Electricity	**3,832**	(3,677)
Deferred Fuel—Electric	**(869)**	(2,806)
Gas Purchased for Resale	**7,038**	(39,168)
Other Operation	**519**	10,830
Maintenance	**6,451**	1,357
Depreciation and Amortization	**14,173**	3,458
Taxes Charged to Operating Expenses	**(9,497)**	(5,621)
Total Change in Operating Expenses	**$25,991**	$(23,715)

gas therm consumption, as adjusted for normal weather, per heating customer and continued growth in the number of gas customers in 1988 and 1987 bolstered therm sales. Also, in 1988 several major dual-fuel industrial customers consistently used gas during the year whereas in 1987 they were fully or partially burning oil.

Operating Expenses

Compared with the prior year, operating expenses increased 4.3 percent in 1988 following a 3.7 percent decrease in 1987. The 1988 increase, in part, is due to the recording of Nine Mile Two operation and maintenance expenses commencing in April 1988, as mentioned above. In 1989, pursuant to the terms of the 1988 Rate Agreement, the Company will absorb, or benefit by, the first $825,000 of any Nine Mile Two operating expense variance from a forecasted amount of $13.3 million and then share 50 percent of any remaining variance with its customers. A summary of the change in operating expenses for the 1988 and 1987 comparison periods is presented in the table on page 12.



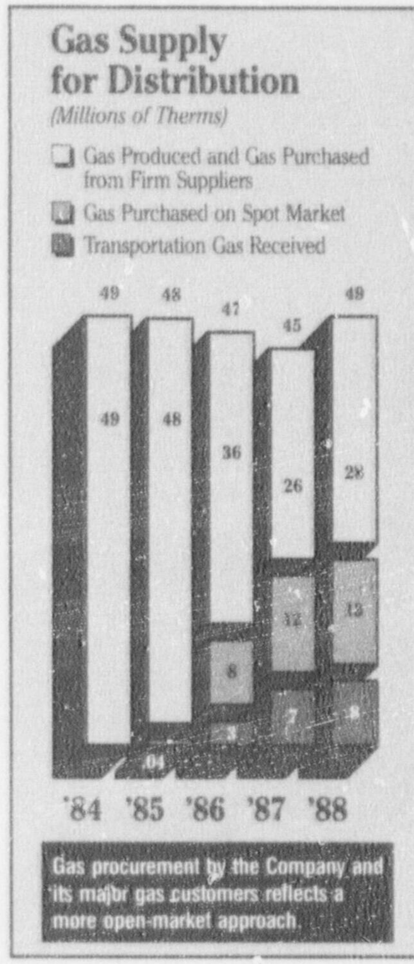
The price of nuclear fuel continues its significant advantage over the cost of fossil fuel.

Energy Costs—Electric. The increase in fuel expenses for electric generation for both comparison periods reflects increased generation from both the Company's fossil-fueled and nuclear generating units, including commercial generation from Nine Mile Two. The increase in fuel expenses, however, was relatively less than the increase in generation, reflecting largely a drop in fuel costs, as illustrated by the graph below left.

Fluctuations in purchased electricity expense resulted primarily from changes in kilowatt-hours purchased, together with increasing average rates in 1987 and 1988.

Energy Costs—Gas. The gas procurement practices of the Company reflect a more open-market approach taking place in the gas utility industry. This approach allows the Company and several of its large-consumption gas customers to take greater advantage of favorable spot market purchases, as illustrated by the graph to the upper right. These purchases, together with contract purchases, provide more flexibility while still assuring an adequate supply of gas. The variation in the cost of gas purchased reflects changes in the volume of gas purchased for the Company's customers, coupled with lower average rates for both comparison periods.

As discussed under the heading New York State Public Service Commission (PSC), the Company at December 31, 1988 had deferred $1.1 million of take-or-pay charges from gas pipeline suppliers. Disposition of such deferred charges, recorded on the Company's Balance Sheet as a



Gas procurement by the Company and its major gas customers reflects a more open-market approach.

deferred asset, is subject to future PSC determination.

Operating Expenses, Excluding Fuel. Excluding accounting procedures which affect certain operating accounts, other operation expenses were unchanged in 1987 in contrast to an increase of approximately $20 million in 1988. These additional other operation expenses in 1988 include $10.7 million of expenses associated with the commercial operation of Nine Mile Two. Increasing other operation expenses in 1987 by $9.5 million was an accounting procedure in connection with the deferral of Nine Mile Two revenues (see Operating Revenues and Sales). With the commercial operation in April 1988 of Nine Mile Two, accounting adjustments were made to reverse prior revenue deferrals which had recognized recovery of Nine Mile Two operation and maintenance expenses prior to the actual commercial operation date. Such accounting adjustments reduced other operation expenses by a net amount of approximately $18 million in 1988.

Higher maintenance expenses in 1988 reflect increased refueling shutdown and maintenance expenses at the Ginna nuclear plant and the recording of Nine Mile Two expenses starting in April 1988. Increased maintenance costs at the Company's fossil-fueled electric generating plants led to higher maintenance costs in 1987 compared to a year earlier.

The recognition of Nine Mile Two depreciation expense, commencing with the commercial operation of the facility in April 1988, was responsible for most of the depreciation and amortization expense variance between the 1988 and 1987 comparison periods.

Taxes. Fluctuations in local, state and other taxes reflect changes in gross income and gross earnings taxes, which are based on revenues, together with the effect of higher property taxes due to higher tax rates and assessments. Over one-half of the increase in local, state and other taxes in the 1988 comparison period resulted from the recognition of these costs as operating expenses once Nine Mile Two entered commercial operation.

In October 1986, the Tax Reform Act of 1986 (Tax Act) was enacted. As a result of the Tax Act, the Company's marginal Federal income tax rate was reduced from 46 percent in 1986 to 40 percent in 1987, with a further reduction to 34 percent in 1988 and thereafter. The Tax Act eliminated investment tax credits and required the inclusion of unbilled revenues in taxable income. The provisions of the Tax Act resulted in higher currently payable Federal income taxes, but a reduced total Federal income tax provision for book purposes. The 1988 Rate Agreement incorporated these tax changes through July 1990 and called for the adjustment of certain accumulated deferred tax balances to the 34 percent level over the two-year period ending July 1990, with the exception of deferred tax balances related to accelerated depreciation and Ginna nuclear plant decommissioning costs. The 1988 Rate Agreement also provided for deferred accounting of any statutory increases or decreases in federal or state taxes which have an impact of $1 million or more on the Company's tax expense and occur subsequent to July 31, 1989. Such deferred balances will be preserved for disposition in the Company's next rate proceeding.

In December 1987, the FASB issued a Statement of Financial Accounting Standards entitled "Accounting for Income Taxes" (SFAS-96). Among other things, SFAS-96 requires the Company to adjust certain of its deferred tax assets and liabilities to reflect periodic changes in tax rates. In addition, the Company may also be required to provide deferred taxes for the effect of tax benefits previously flowed through to the Income Statement. SFAS-96 is not required to be adopted by the Company until the first quarter of 1990. The Company is presently unable to estimate the effects of the adoption of SFAS-96, but absent additional changes in the Federal tax code and as the result of certain tax-related provisions contained in the 1988 Rate Agreement (see previous paragraph), the Company does not believe the earnings impact to be significant.

Other Statement of Income Items

As discussed above, the Company's 1987 Statement of Income reflects the cumulative effect as of January 1, 1987 of an accounting change in connection with the write-off of disallowed Nine Mile Two plant costs in 1987. Disallowed costs for the period subsequent to January 1, 1987 are reported under the caption "Other Income and Deductions" on the Statement of Income.

AFUDC variances are generally related to the amount of utility plant under construction not included in rate base. AFUDC was not recognized on disallowed Nine Mile Two plant costs; and, for 1988 and 1987, the amount of AFUDC reported reflects such disallowance. AFUDC reported in prior years has not been restated for such disallowed costs as a result of the accounting change adopted by the Company and referenced above. Compared to 1987, the lower level of AFUDC for 1988 resulted primarily from the transfer of Nine Mile Two utility plant under construction not included in rate base to plant-in-service in April 1988.

Other Income includes $6.4 million of non-cash earnings in 1987 and $4.5 million in 1986 associated with the amortization of certain customer prepaid Nine Mile Two financing costs which had been deferred, as discussed under the heading New York State Public Service Commission (PSC). Other Income in 1988 resulted mainly from interest income on temporary cash investments.

Despite the issuance of additional long-term debt over the three-year period 1986–1988, long-term debt interest expense during this period declined primarily as a result of the Company's optional redemptions of certain high-cost first mortgage bonds.

Earnings/Summary

Presented on page 15 is a table which summarizes the Company's common earnings in total and on a per-share basis as reported and as modified to exclude disallowed Nine Mile Two costs written off in 1987 and to exclude AFUDC on these costs in

1987 and 1986. AFUDC as a percentage of such modified common earnings is presented in the graph below. No additional Nine Mile Two plant costs were written off in 1988. As discussed under the heading Nine Mile Two, future adjustment to the 1987 write-off may be recognized by the Company upon recognition by the PSC of a definitive commercial operation date for Nine Mile Two and the resolution of certain issues being disputed with the PSC regarding the implementation of the Nine Mile Two Settlement (see Note 10 of the Notes to Financial Statements).

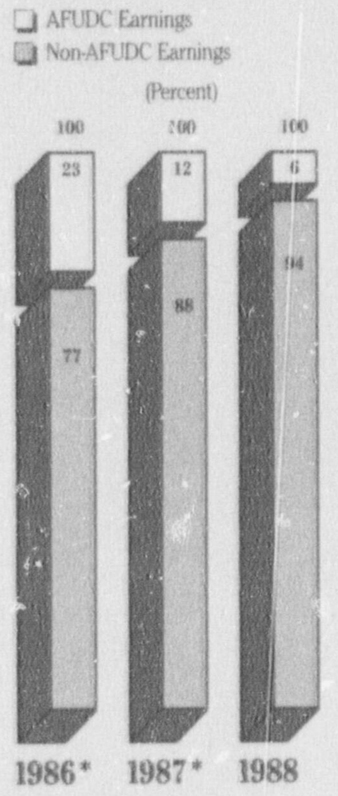
In September 1987 the Company announced a reduction in its quarterly dividend rate from $.55 per share to $.375 per share, or $1.50 on an annual basis. This adjusted dividend rate which has been paid quarterly since the fourth quarter of 1987, resulted from the Company's analysis of the PSC's 1987 rate decision which indicated that anticipated earnings were not expected to cover Common Stock dividends at the former rate. Although the Company believes that the current annual Common Stock dividend rate of $1.50 per share is sustainable, its ability to maintain the Common Stock dividend level and its Preferred Stock dividend is necessarily dependent on future earnings, which the Company cannot predict. The Company's Charter provides for the payment of dividends on Preferred Stock and Common Stock out of the surplus net profits (retained earnings) of the Company. The Company would not be able to pay Preferred or Common Stock dividends unless positive retained earnings were maintained. As of December 31, 1988 the Company's retained earnings were approximately $39.7 million. The Company presently intends to establish a retained earnings base at least equal to its annual dividend requirement for both preferred and common stocks before considering an increase in the Common Stock dividend rate above the annual rate of $1.50 per share.

Earnings Summary

	Earnings (Thousands of Dollars)	Shares[1] (Thousands)	Earnings per Share
1988			
As Reported	$ 68,766	30,5[illegible]	$ 2.25
1987			
As Reported	$(176,858)	29,728	$(5.95)
Excluding Nine Mile Two Write-Off	$ 63,042[2]	29,728	$ 2.12
1986			
As Reported	$ 96,461	28,927	$ 3.33
Excluding Nine Mile Two Write-Off	$ 67,161[2]	28,927	$ 2.32

[1] *Weighted average shares outstanding.*
[2] *Reported earnings modified to exclude disallowed Nine Mile Two costs written off in 1987 and to exclude AFUDC on these costs in 1987 and 1986. See Note 10 of the Notes to Financial Statements.*

AFUDC as a Percent of Earnings



*Earnings modified to exclude disallowed Nine Mile Two costs written off in 1987 and to exclude AFUDC on these costs in 1986 and 1987.

The quality of earnings is improved with a lower level of AFUDC earnings.

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Statement of Income

(Thousands of Dollars)	Year Ended December 31	1988	1987	1986
Operating Revenues	Electric	**$513,617**	$ 489,215	$466,496
	Gas	**230,395**	216,058	261,688
		744,012	705,273	728,184
	Electric sales to other utilities	**29,966**	26,215	20,465
	Total Operating Revenues	**773,978**	731,488	748,649
Operating Expenses	Fuel Expenses			
	Fuel for electric generation	**65,787**	61,443	49,531
	Purchased electricity	**30,299**	26,467	30,144
	Electric deferred fuel	**(1,020)**	(151)	2,655
	Gas purchased for resale	**128,774**	121,736	160,904
	Total Fuel Expenses	**223,840**	209,495	243,234
	Operating Revenues Less Fuel Expenses	**550,138**	521,993	505,415
	Other Operating Expenses			
	Operations excluding fuel expenses	**159,689**	159,170	148,340
	Maintenance	**52,575**	46,124	44,767
	Depreciation and amortization	**69,703**	55,530	52,072
	Taxes—local, state and other	**88,635**	82,869	84,590
	Federal income tax	**40,662**	55,925	59,825
	Total Other Operating Expenses	**411,264**	399,618	389,594
	Operating Income	**138,874**	122,375	115,821
Other Income and Deductions	Allowance for other funds used during construction	**2,047**	5,030	32,828
	Federal income tax	**1,683**	17,520	13,880
	Disallowed project costs	**—**	(55,860)	—
	Other, net	**6,901**	8,831	6,725
	Total Other Income and Deductions	**10,631**	(24,479)	53,433
	Income Before Interest Charges	**149,505**	97,896	169,254
Interest Charges	Long term debt	**72,270**	73,489	74,571
	Other, net	**2,898**	2,814	2,142
	Allowance for borrowed funds used during construction	**(1,777)**	(2,696)	(11,978)
	Total Interest Charges	**73,[illegible]**	73,607	64,735
	Income Before Cumulative Effect of Accounting Change	**76,114**	24,289	104,519
	Cumulative Effect for Years Prior to 1987 of Accounting Change for Disallowed Costs (less related Federal income tax benefits of $65,000)	**—**	(193,000)	—
	Net Income (Loss)	**76,114**	(168,711)	104,519
	Dividends on Preferred Stock	**7,348**	8,147	8,058
	Earnings (Loss) Applicable to Common Stock	**$ 68,766**	$(176,858)	$ 96,461
	Weighted Average Number of Shares for Period (000's)	**30,513**	29,728	28,927
	Earnings (Loss) per Common Share			
	—Before Cumulative Effect of Accounting Change	**$2.25**	$ .54	$3.33
	—Cumulative Effect of Accounting Change	**—**	(6.49)	—
	Total	**$2.25**	$(5.95)	$3.33

Statement of Retained Earnings

(Thousands of Dollars)	Year Ended December 31	1988	1987	1986
	Balance at Beginning of Period	**$ 17,617**	$ 249,505	$216,795
	Add			
	Net Income (Loss)	**76,114**	(168,711)	104,519
	Total	**93,731**	80,794	321,314
	Deduct			
	Dividends declared on capital stock			
	Cumulative preferred stock	**7,348**	8,147	8,058
	Common stock	**45,832**	55,030	63,751
	Preferred stock redemption	**841**	—	—
	Total	**54,021**	63,177	71,809
	Balance at End of Period	**$ 39,710**	$ 17,617	$249,505

The accompanying notes are an integral part of the financial statements.

Balance Sheet

(Thousands of Dollars)	At December 31	1988	1987
Assets	**Utility Plant**		
	Electric	$1,558,001	$1,031,334
	Gas	272,377	258,828
	Common	86,523	81,637
	Nuclear fuel	206,021	188,049
		2,122,922	1,559,848
	Less: Accumulated depreciation	507,948	457,605
	Nuclear fuel amortization	145,928	129,235
		1,469,046	973,008
	Construction work in progress	41,044	501,738
	Net Utility Plant	1,510,090	1,474,746
	Current Assets		
	Cash and cash equivalents	73,031	60,146
	Accounts receivable, net of allowance for doubtful accounts: 1988—$5,526; 1987—$5,498	63,728	53,709
	Unbilled revenue receivable	45,853	—
	Receivable under Nine Mile cotenant agreement	—	40,600
	Materials and supplies, at average cost		
	Fossil fuel	8,220	9,707
	Construction and other supplies	9,178	10,544
	Prepayments	11,303	9,603
	Total Current Assets	211,313	184,309
	Deferred Debits		
	Sterling project property loss	10,537	19,052
	Unamortized debt expense	13,072	14,678
	Deferred finance charges—Nine Mile project	44,656	73,631
	Other	33,750	24,165
	Total Deferred Debits	102,015	131,526
	Total Assets	$1,823,418	$1,790,581
Capitalization and Liabilities	**Capitalization**		
	Long term debt—mortgage bonds	$ 651,076	$ 703,426
	—promissory notes	141,900	141,900
	Preferred stock redeemable at option of Company	67,000	67,000
	Preferred stock subject to mandatory redemption	30,000	50,797
	Common shareholders' equity		
	Common stock	504,907	494,018
	Retained earnings	39,710	17,617
	Total Common Shareholders' Equity	544,617	511,635
	Total Capitalization	1,434,593	1,474,758
	Long Term Liability—Department of Energy	51,016	47,773
	Current Liabilities		
	Long term debt due within one year	34,750	2,750
	Preferred stock redeemable within one year	—	812
	Accounts payable	37,031	32,833
	Dividends payable	13,054	13,297
	Taxes accrued	5,992	3,423
	Interest accrued	15,652	15,922
	Pension costs accrued	1,885	1,359
	Other	17,869	20,108
	Total Current Liabilities	126,233	90,504
	Deferred Credits and Other Liabilities		
	Accumulated deferred income taxes	117,345	86,884
	Deferred unbilled revenue	39,780	—
	Deferred finance charges—Nine Mile project	44,656	73,631
	Other	9,795	17,031
	Total Deferred Credits and Other Liabilities	211,576	177,546
	Commitments and Other Matters *(Notes 10 and 11)*		
	Total Capitalization and Liabilities	$1,823,418	$1,790,581

The accompanying notes are an integral part of the financial statements.

Statement of Cash Flows

(Thousands of Dollars)	Year Ended December 31	1988	1987	1986
Cash Flow from Operations	**Net income (loss)**	**$ 76,114**	$(168,711)	$ 104,519
	Adjustments to reconcile net income to net cash provided from operating activities:			
	Depreciation and amortization	**69,703**	55,530	52,072
	Amortization of nuclear fuel	**19,945**	20,678	18,598
	Deferred fuel—electric	**(1,020)**	(151)	2,655
	Deferred income taxes, net	**28,124**	4,984	22,810
	Allowance for funds used during construction	**(3,824)**	(7,726)	(44,806)
	Disallowed project costs—Nine Mile plant	**—**	248,860	—
	Unbilled revenue, net	**(8,528)**	—	—
	Changes in certain current assets and liabilities:			
	Accounts receivable	**(10,019)**	746	12,037
	Receivable under Nine Mile cotenant agreement	**40,600**	—	(40,600)
	Materials and supplies—fossil fuel	**1,487**	3,444	(1,438)
	—construction and other supplies	**1,366**	527	(1,770)
	Taxes accrued	**2,569**	7,105	(4,981)
	Accounts payable	**4,724**	5,014	(17,669)
	Interest accrued	**(270)**	1,686	(349)
	Other current assets and liabilities, net	**(3,928)**	5,891	2,694
	Other, net	**(6,644)**	(4,972)	(3,021)
	Total Operating	**$ 210,399**	$ 172,905	$ 100,751
Cash Flow from Investing Activities	**Utility Plant**			
	Plant additions	**$ (96,439)**	$(110,139)	$(194,315)
	Receivable under Nine Mile cotenant agreement	**—**	—	40,600
	Nuclear fuel additions	**(17,972)**	(18,552)	(14,893)
	Less: Allowance for funds used during construction	**3,824**	7,726	44,806
	Additions to Utility Plant	**(110,587)**	(120,965)	(123,802)
	Sterling project property loss	**(95)**	17,023	—
	Other, net	**(1,056)**	(436)	(548)
	Total Investing	**$(111,738)**	$(104,378)	$(124,350)
Cash Flow from Financing Activities	**Proceeds from:**			
	Sale of common stock	**$ 11,189**	$ 16,268	$ 18,827
	Sale of preferred stock	**—**	30,000	—
	Sale of long term debt, mortgage bonds	**25,500**	75,000	75,000
	Sale of long term debt, promissory notes	**—**	50,000	—
	Net borrowings (repayments) under:			
	Short term debt, net	**—**	(18,000)	18,000
	Retirements of:			
	Preferred stock	**(22,758)**	(23,462)	(2,472)
	Long term debt	**(45,833)**	(67,750)	(52,750)
	Capital stock expense	**8**	(1,993)	(166)
	Discount and expense of issuing long term debt	**(496)**	(4,476)	(3,729)
	Dividends paid on preferred and common stock	**(53,423)**	(67,949)	(71,459)
	Other, net	**37**	203	86
	Total Financing	**$ (85,776)**	$ (12,159)	$ (18,663)
	Increase (decrease) in cash and cash equivalents	**$ 12,885**	$ 56,368	$ (42,262)
	Cash and cash equivalents at beginning of year	**$ 60,146**	$ 3,778	$ 46,040
	Cash and cash equivalents at end of year	**$ 73,031**	$ 60,146	$ 3,778

Supplemental Disclosure of Cash Flow Information

	Year Ended December 31	1988	1987	1986
Cash Paid During the Year	**Interest paid (net of capitalized amount)**	**$ 71,124**	$ 62,175	$ 63,485
	Income taxes paid	**$ 10,521**	$ 22,404	$ 28,998

The accompanying notes are an integral part of the financial statements.

Notes to Financial Statements

Note 1. Summary of Accounting Policies

General. The Company is subject to regulation by the Public Service Commission of the State of New York (PSC) under New York statutes and by the Federal Energy Regulatory Commission (FERC) as a licensee and public utility under the Federal Power Act. The Company's accounting policies conform to generally accepted accounting principles as applied to New York State public utilities giving effect to the rate-making and accounting practices and policies of the PSC.

In December 1986, the Financial Accounting Standards Board (FASB) issued its Statement of Financial Accounting Standards No. 90 (SFAS-90) with respect to, among other things, the financial accounting for disallowed costs of recently completed plants. Under SFAS-90, a loss must be recognized when it becomes probable that some portion of the costs of the plant will be disallowed for rate-making purposes and a reasonable estimate of the amount of the disallowance can be made. SFAS-90 is generally effective beginning in 1988 with earlier application encouraged, but applies to plant costs disallowed prior thereto. The Company elected to adopt SFAS-90 in the third quarter of 1987 for its investment in Nine Mile Point Nuclear Plant Unit No. 2 (Unit 2).

In adopting SFAS-90, the Company presented the cumulative effect of the accounting change prior to January 1, 1987 in the Statement of Income rather than restate previously issued financial statements. Refer to Note 10 for additional information.

In November 1987, the FASB issued SFAS-95, which established a Statement of Cash Flows that replaced the Statement of Changes in Financial Position. This new standard was adopted by the Company in 1988. For comparative purposes, the Company has retroactively applied the provisions of SFAS-95 to 1987 and 1986. For purposes of this statement, the Company considers cash equivalents to be short-term investments of three months or less.

In June 1988, the Board of Directors authorized the creation of Utilicom, Inc. as a wholly owned subsidiary. Utilicom develops and markets computer software to assist customers in complying with state and federal environmental and safety regulations. Authorization from the PSC is pending and the subsidiary activity has to date been insignificant.

A description of the Company's principal accounting policies follows.

Rates and Revenue. Revenue in 1987 and 1986 was recorded on the basis of meters read during the calendar year. In addition, beginning in July 1988, as part of a rate decision, the PSC approved recording of unbilled revenue. Accordingly, approximately $42 million associated with the change in accounting will be amortized to income during the period July 1988 to July 1990. Unbilled revenue recognizes service rendered subsequent to the meter read date but prior to the end of the accounting period. In connection with the change in accounting, approximately $7.2 million and $1.3 million have been recognized in the Statement of Income in 1988 for electric and gas, respectively.

Tariffs for electric and gas service include fuel cost adjustment clauses which adjust the rates monthly to reflect changes in the actual average cost of fuels. The electric fuel adjustment provides that ratepayers and the Company will share the effects of any variation from forecast monthly unit fuel costs on an 80%/20% basis up to a $2.6 million cumulative, after tax, annual gain or loss to the Company. Thereafter, 100 percent of additional fuel clause adjustment amounts are assigned to ratepayers. There is also an 80%/20% sharing of variances in gains or losses from PSC established forecast amounts related to margins on electricity sales to other electric utilities. In addition, there is a similar 80%/20% sharing process of variances from forecasted revenues derived from sales to large gas customers that can use alternate fuels. This process limits any loss to the Company to $1 million pretax per year if these customers utilize their alternative fuels.

The gas department tariffs provide a separate but equivalent rate, excluding the cost of gas, to reflect charges for the transportation of privately owned gas through the Company's facilities.

Deferred Fuel Costs. Fuel costs which are recoverable under the electric and gas cost adjustment clauses included in the tariff schedules of the Company are deferred until they are billed to customers. A reconciliation of recoverable gas costs with gas revenues is done annually as of August 31, and the excess or deficiency is refunded to or recovered from the customers during a subsequent twelve-month period.

Utility Plant, Depreciation and Amortization. The cost of additions to utility plant and replacement of retirement units of property is capitalized. Cost includes labor, material, and similar items, as well as indirect

(Note 1 continued on page 20)

(Continued from page 19)

charges such as engineering and supervision, and is recorded at original cost. See Note 10 for discussion of Unit 2. The Company capitalizes an allowance for funds used during construction approximately equivalent to the cost of capital devoted to plant under construction that is not included in its rate base. Replacement of minor items of property is included in maintenance expenses. Costs of depreciable units of plant retired are eliminated from utility plant accounts, and such costs, plus removal expenses, less salvage, are charged to accumulated depreciation and amortization.

Depreciation in the financial statements is provided on a straight-line basis at rates based on the estimated useful lives of property, which have resulted in provisions of 3.6% per annum of average depreciable property in each of the last three years. Amortization includes $8.6 million in 1988, $6.5 million in 1987 and $5.5 million in 1986 related to the Sterling project property loss.

Nuclear Fuel Disposal Costs. The Nuclear Waste Policy Act (Act) of 1982, as amended, requires the United States Department of Energy (DOE) to establish a nuclear waste disposal site by 1998 and to take title to nuclear waste. The Act provides for a determination of the fees collectible by the DOE for the disposal of nuclear fuel irradiated prior to April 7, 1983 and for three payment options. The option of a single payment to be made at any time prior to the first delivery of fuel to the DOE was selected in June 1985. The Company estimates the fees, including accrued interest, owed to the DOE to be approximately $51.0 million at December 31, 1988. The Company has collected in rates an amount sufficient for the disposal of nuclear fuel irradiated prior to April 7, 1983. The estimated fees are classified as a long-term liability and interest is accrued on a quarterly basis. The Act also provides for the disposal of nuclear fuel irradiated after April 6, 1983, in exchange for a charge of one mill ($.001) per KWH generated at nuclear plants. This charge is currently being collected from customers and paid to the DOE pursuant to PSC authorization.

Nuclear Decommissioning Costs. Decommissioning costs (costs to take the plant out of service in the future) for the Company's Ginna Nuclear Plant are estimated by the PSC to be approximately $179.1 million in the year 2006 when the permanent license expires, and the Company's share of Unit 2's decommissioning costs are estimated to be approximately $135.4 million at license expiration in the year 2026. Through December 31, 1988, the Company has accrued and recovered in rates $22.1 million for this purpose and is currently accruing additions to a reserve at a rate of approximately $3.5 million per year based on a graduated revenue requirement methodology adopted by the PSC. (See Note 11.)

Allowance for Funds Used During Construction. The Company capitalizes an Allowance for Funds Used During Construction (AFUDC) based upon the net cost of borrowed funds for construction purposes, and a reasonable rate upon the Company's other funds when so used. In accordance with an order issued by the FERC, AFUDC is segregated into two components and classified in the Statement of Income as Allowance for Borrowed Funds Used During Construction, an offset to Interest Charges, and Allowance for Other Funds Used During Construction, a part of Other Income.

Effective July 16, 1984, pursuant to PSC authorization, the Company discontinued accruing AFUDC on $50 million of construction work in progress related to its investment in Unit 2 for which a cash return was being allowed through its inclusion in rate base. An additional $150 million and $230 millon were included in rate base, effective July 9, 1985 and July 14, 1986, respectively, as authorized by the PSC, and AFUDC accruals were likewise discontinued. The PSC also ordered in 1984 that amounts be accumulated in deferred debit and credit accounts equal to the amount of AFUDC which was no longer accrued. The balance in the deferred credit account would be available to reduce future revenue requirements over a period substantially shorter than the life of Unit 2 and the balance in the deferred debit account would then be collected from customers over a longer period of time. In July 1988, in accordance with PSC Opinion 88-21, the Company eliminated by offset one-half of the deferred debit and credit balances in connection with the unused portion of customer prepaid financing costs associated with Unit 2 (See Note 10), reducing the cumulative balance to $44.7 million. In accordance with PSC Opinion 86-17, issued July 14, 1986, $10.875 million of these accruals were amortized over the rate year commencing August 1, 1986. The deferred credit was discharged through the Income Statement in 1986 and

1987, while the deferred debit was reclassified into a separate deferred debit account. In connection with the Company's current rate settlement, approximately $4 million will be amortized through the income statement commencing August 1, 1989.

In September 1987, the Company wrote off $22.1 million in AFUDC that had been recorded in 1987 applicable to PSC disallowed expenditures in Unit 2.

The gross rates approved by the PSC for purposes of computing AFUDC were: 10.25% effective January 1, 1988; 10.20% effective August 1, 1987 through December 31, 1987; 10.60% effective August 1, 1986 through July 31, 1987; and 12.00% effective for the seven months ended July 31, 1986. AFUDC on certain major construction projects, however, including Unit 2, has been applied at a reduced rate which is net of the income tax effect of the interest portion of AFUDC. The net-of-tax rates used on these projects for 1988, 1987 and 1986 were 8.55%, 8.47% and 9.32%, respectively.

Federal Income Tax. For income tax purposes, depreciation is computed using the most liberal methods permitted. In addition, certain costs capitalized for financial reporting purposes were deducted currently for income tax purposes in accordance with the Internal Revenue Code prior to the enactment of the Tax Reduction Act of 1986. The resulting tax reductions were offset by provisions for deferred income taxes only to the extent ordered or permitted by regulatory authorities. The cumulative balance of tax deductions not offset by provisions for deferred income taxes through 1988 is approximately $395 million.

The Company provides for full normalization of depreciation and investment tax credits. The Tax Reform Act of 1986 provided for the repeal of investment tax credits; however, some credits continue to be available under the transitional rules contained in the Tax Act.

The Company uses the separate-period approach in calculating the interim quarterly tax provision.

SFAS-96, Accounting for Income Taxes (as amended by SFAS-100), was issued in December of 1987 and has not yet been adopted by the Company. SFAS-96 requires adoption in calendar year 1990 and that a deferred tax liability or asset be adjusted in the period of enactment for the effect of changes in tax laws or rates. Additionally, the Company may also be required to provide deferred taxes for the effect of taxes previously flowed through the Income Statement. The Company is presently unable to estimate the effects of the adoption of SFAS-96, but absent additional changes in the Federal tax code, the Company does not believe the earnings impact to be significant.

Retirement Health Care and Life Insurance Benefits. The Company provides certain health care and life insurance benefits for retired employees and health care coverage for surviving spouses of retirees. Substantially all of the Company's employees may become eligible for these benefits if they reach retirement age while working for the Company. These and similar benefits for active employees are provided through insurance companies whose premiums are based upon the experience of benefits actually paid. The Company recognizes the costs of providing these benefits by a current charge to expense. The cost of providing these benefits was approximately $1.8 million in 1988, $1.8 million in 1987 and $1.6 million in 1986.

Earnings and Dividends Per Share. Earnings applicable to each share of common stock are based on the weighted average number of shares outstanding during the respective years. The pro forma earnings (loss) per share, assuming the accounting change described above and in Note 10 was applied retroactively, are $.54 in 1987 and $(3.33) in 1986.

Notes to Financial Statements

Note 2. Federal Income Taxes *(Thousands of Dollars)*

The provision for Federal income taxes is distributed between operating expense and other income based upon the treatment of the various components of the provision in the rate-making process. The following is a summary of income tax expense for the three most recent years.

	1988	1987	1986
Charged to operating expense:			
Current	$20,363	$ 32,781	$ 22,521
Deferred	20,299	23,144	37,304
Total	40,662	55,925	59,825
Charged (Credited) to other income:			
Current	(9,508)	640	614
Deferred	7,825	(18,160)	(14,494)
Total	(1,683)	(17,520)	(13,880)
Total Federal income tax expense	$38,979	$ 38,405	$ 45,945

The following is a reconciliation of the difference between the amount of Federal income tax expense reported in the Statement of Income and the amount computed by multiplying the income by the statutory tax rate.

	1988		1987		1986	
	Amount	% of Pretax Income	Amount	% of Pretax Income	Amount	% of Pretax Income
Income before cumulative effect of accounting change	$ 76,114		$24,289		$104,519	
Add: Federal income tax expense	38,979		38,405		45,945	
Income before Federal income tax	$115,093		$62,694		$150,464	
Computed tax expense	$ 39,132	34.0	$25,078	40.0	$ 69,213	46.0
Increases (decreases) in tax resulting from:						
Expenses capitalized for financial reporting purposes	—		(8,337)	(13.3)	(23,168)	(15.4)
Disallowed project costs	—		15,064	24.0	—	
Difference between tax depreciation and amount deferred	1,626	1.4	4,312	6.9	3,885	2.6
Investment tax credit	(3,763)	(3.2)	(3,701)	(5.9)	(5,177)	(3.4)
Tax Reduction Act benefits deferred	—		4,561	7.3	—	
Miscellaneous items, net	1,984	1.7	1,428	2.3	1,192	.7
Total Federal income tax expense	$ 38,979	33.9	$38,405	61.3	$ 45,945	30.5

A summary of the deferred amounts charged or (credited) to income is as follows:

	1988	1987	1986
Investment tax credit	$ (3,763)	$ (4,619)	$10,145
Depreciation	29,519	26,956	12,855
Fuel costs	2,681	1,086	(5,035)
Sterling abandonment	585	(8,249)	(1,597)
Capitalized overheads	(265)	3,410	4,278
Accrued revenue	(442)	(4,740)	—
Disallowed project costs	—	(8,960)	—
Other items	(191)	100	2,164
Total	$28,124	$ 4,984	$22,810

Note 3. Pension Plan

The Company has a defined benefit pension plan covering substantially all of its employees. The benefits are based on years of service and the employee's compensation during the last three years of employment. The Company's funding policy is to contribute annually an amount consistent with the requirements of the Employee Retirement Income Security Act. These contributions are intended to provide for benefits attributed to service to date and for those expected to be earned in the future.

The plan's funded status and amounts recognized on the Company's Balance Sheet are as follows:

	(Millions) 1988	1987
Accumulated benefit obligation, including vested benefits of $179.1 in 1988 and $180.2 in 1987	$191.3*	$193.3*
Projected benefit obligation for service rendered to date	$276.4*	$285.0*
Less—Plan assets at fair value, primarily listed stocks and bonds	303.8	276.9
	(27.4)	8.1
Unrecognized net gain or (loss) from past experience different from that assumed and effects of changes in assumptions	36.4	(1.5)
Less—Prior service cost not yet recognized in net periodic pension cost	.1	—
Less—Unrecognized net obligation at December 31	7.0	5.3
Prepaid pension cost (pension liability) recognized on the balance sheet	$ (1.9)	$ (1.3)

Actuarial present value

Net pension cost included the following components:

	(Millions) 1988	1987
Service cost—benefits earned during the period	$ 6.9	$ 7.2
Interest cost on projected benefit obligation	22.5	20.4
Actual return on plan assets	(31.0)	(18.2)
Net amortization and deferral	12.4	1.3
Net periodic pension cost	$ 10.8	$ 10.7

The projected benefit obligation at December 31, 1988 and 1987 assumed discount rates of 8½ percent and 8 percent, respectively, and a long-term rate of increase in future compensation levels of 7 percent. The assumed long-term rate of return on plan assets was 8 percent. The unrecognized net obligation is being amortized over 15 years beginning January 1, 1986.

Pension cost for 1988, 1987, and 1986 was $10.8 million, $10.7 million, and $10.0 million, respectively. The PSC has directed the Company to defer for future disposition any differences resulting from the calculation of pension cost pursuant to SFAS-87.

Note 4. Departmental Financial Information

The Company's records are maintained by operating departments, in accordance with PSC accounting policies, giving effect to the rate-making process. The following is the operating data for each of the Company's departments, and no interdepartmental adjustments are required to arrive at the operating data included in the Statement of Income.

		(Thousands of Dollars)		
		1988	1987	1986
Electric	**Operating information**			
	Operating revenues	$ 543,583	$ 515,430	$ 486,961
	Operating expenses, excluding provision for income taxes	390,867	360,000	337,467
	Pretax operating income	152,716	155,430	149,494
	Provision for income taxes	34,093	48,788	52,051
	Net operating income	$ 118,623	$ 106,642	$ 97,443
	Other information			
	Depreciation and amortization	$ 60,444	$ 46,776	$ 43,753
	Nuclear fuel amortization	$ 19,945	$ 20,678	$ 18,596
	Capital expenditures	$ 91,941	$ 104,295	$ 108,095
	Investment information			
	Identifiable assets (a)	$1,469,571	$1,483,860	$1,729,194
Gas	**Operating information**			
	Operating revenues	$ 230,395	$ 216,058	$ 261,688
	Operating expenses, excluding provision for income taxes	203,575	193,188	235,536
	Pretax operating income	26,820	22,870	26,152
	Provision for income taxes	6,569	7,137	7,774
	Net operating income	$ 20,251	$ 15,733	$ 18,378
	Other information			
	Depreciation and amortization	$ 9,259	$ 8,754	$ 8,319
	Capital expenditures	$ 18,646	$ 16,670	$ 15,707
	Investment information			
	Identifiable assets (a)	$ 257,200	$ 224,391	$ 219,716

(a) Excludes cash, unamortized debt expense and other common items.

Note 5. Jointly-Owned Facilities

The following table sets forth the jointly-owned electric generating facilities in which the Company is participating. Both Oswego Fossil Unit No. 6 and Nine Mile Point Nuclear Plant Unit No. 2 have been constructed and are operated by Niagara Mohawk Power Corporation. Each participant must provide its own financing for any additions to the facilities. The Company's share of direct expenses associated with these two units is included in the appropriate operating expenses in the Statement of Income. Allowance for funds used during construction have been excluded from the construction costs presented below. Various modifications will be made throughout the lives of these plants to increase operating efficiency or reliability, and to satisfy changing environmental and safety regulations.

	Oswego Fossil Unit #6	Nine Mile Point Nuclear Unit #2
Net megawatt capacity	850	1,080
RG&E's share—megawatts	204	151
—percent	24	14
Year of completion	1980	1988
	(Millions of Dollars)	
Total estimated project costs		$4,214.0
RG&E's share		591.0
RG&E's actual construction costs		
—1987	$ 0.7	$ 36.0
—1988	0.6	12.2
Expended by RG&E in prior years	76.7	539.8
	$78.0	$588.0

For further information regarding Nine Mile Point Nuclear Plant Unit No. 2 refer to Note 10. Pursuant to Statement of Financial Accounting Standards No. 90, the Company, during 1987, completed a write-off in recognition of a regulatory disallowance of a portion of the Nine Mile Nuclear Plant Unit No. 2 facility for rate-making purposes. The disallowance is not included in this table. Niagara Mohawk Power Corporation estimated total project cost, including allowance for funds used during construction and prepaid financing costs, which are excluded from the table above, to be $6,533.0 million. Also not included are Company costs for initial fuel loading ($13.0 million), common facilities ($20.0 million), operating spare parts, transmission facilities, post-in-service additions, and Company direct costs.

Note 6. Long Term Debt

Mortgage Bonds

%	Series	Due	(Thousands) Principal Amount December 31 1988	1987
First Mortgage Bonds				
5	S	Oct. 15, 1989	$ 12,000	$ 12,000
4½	T	Nov. 15, 1991	15,000	15,000
4⅝	U	Sept. 15, 1994	16,000	16,000
5.3	V	May 1, 1996	18,000	18,000
6¼	W	Sept. 15, 1997	20,000	20,000
6.7	X	July 1, 1998	30,000	30,000
8	Y	Aug. 15, 1999	30,000	30,000
9⅛	Z	Sept. 1, 2000	30,000	30,000
9¼	BB	June 15, 2006	50,000	50,000
8⅜	CC	Sept. 15, 2007	50,000	50,000
9½	DD	Dec. 1, 2003	40,000	40,000
6½	EE	Aug. 1, 2009	10,000	10,000
10.95	FF	Feb. 15, 2005	44,000	49,500
*2¼	HH	May 15, 2012	10,500	10,500
13⅞	JJ	June 15, 1999	25,000	25,000
11¼	KK	May 15, 1995	49,667	50,000
8.6	LL	Aug. 1, 1993	75,000	75,000
8⅞	MM	May 1, 1992	75,000	75,000
11¾	NN	June 15, 1993	60,000	
8⅜	OO	Dec. 1, 2028	25,500	
Second Mortgage Bonds				
11¾	A	June 15, 1993		100,000
			685,667	706,000
Net bond premium (discount)			159	176
Less: Due within one year			34,750	2,750
Total Long Term Debt			$651,076	$703,426

The First Mortgage provides security for the bonds through a first lien on substantially all the property owned by the Company (except cash and accounts receivable).

Sinking and improvement fund requirements aggregate $333,540 per annum under the First Mortgage, excluding mandatory sinking funds of individual series. Such requirements may be met by certification of additional property or by depositing cash with the Trustee. The 1987 requirement was met by certification of additional property. The 1988 requirement was met with funds deposited with the Trustee, and these funds were used for redemption of outstanding bonds of Series KK.

The Series EE, Series HH and Series OO First Mortgage Bonds equal the principal amount of and provide for all payments of principal, premium and interest corresponding to the Pollution Control Revenue Bonds,

(Note 6 continued on page 26)

Notes to Financial Statements

(Continued from page 25)

Series A, Series B and Series C, respectively (Rochester Gas and Electric Corporation Projects) issued by the New York State Energy Research and Development Authority through a participation agreement with the Company. The Series EE bonds are subject to a mandatory sinking fund beginning August 1, 2000 and each August 1 thereafter. Nine annual deposits aggregating $3.2 million will be made to the sinking fund, with the balance of $6.8 million principal amount of the bonds becoming due August 1, 2009.

The Series FF First Mortgage Bonds are subject to a mandatory sinking fund of $2.75 million annually which began on February 15, 1986 and will continue each February 15, with the noncumulative option to double the payment in any year up to a maximum of 5 years. In February 1988 and 1989, the Company exercised this option and redeemed an additional $2.75 million of Series FF Bonds in each year.

The Series JJ First Mortgage Bonds are subject to a mandatory sinking fund of $2.5 million annually beginning June 15, 1990 and each June 15 thereafter.

The Series LL and MM First Mortgage Bonds are not redeemable prior to maturity.

In January 1988 the Company redeemed the Series A Second Mortgage Bonds and exchanged them for Series NN First Mortgage Bonds. All terms and conditions of the Series NN Bonds are substantially identical to the redeemed Series A Bonds. The Series NN First Mortgage Bonds are subject to a mandatory sinking fund of $20.0 million annually beginning June 15, 1989 and each June 15 thereafter. On November 1, 1988 the Company exercised its option to redeem $40 million principal amount of these bonds at a price of 105.22%.

The bonds maturing in the next five years are $12 million in 1989 for Series S, $15 million in 1991 for Series T, $20 million in 1991 for Series NN, $75 million in 1992 for Series MM, and $75 million in 1993 for Series LL.

The sinking fund requirements for the next five years are:

	(Thousands)				
	1989	1990	1991	1992	1993
Series NN	$20,000	$20,000	$20,000		
Series FF	2,750	2,750	2,750	$2,750	$2,750
Series JJ		2,500	2,500	2,500	2,500
	$22,750	$25,250	$25,250	$5,250	$5,250

Promissory Notes

		(Thousands)	
		December 31	
Issued	Due	1988	1987
November 15, 1984	October 1, 2014	$ 51,700	$ 51,700
December 5, 1985	November 15, 2015	40,200	40,200
July 22, 1987	July 15, 2027	50,000	50,000
Total		$141,900	$141,900

The Company is obligated to make payments of principal, premium and interest on each Promissory Note which correspond to the payments of principal, premium, if any, and interest on certain Pollution Control Revenue Bonds issued by the New York State Energy Research and Development Authority (NYSERDA) as described below. These obligations under each note shall be deemed satisfied to the extent of funds drawn under certain Letters of Credit discussed below. Any amounts advanced under such Letters of Credit must be repaid, with interest, by the Company.

The $51.7 million Promissory Note was issued in connection with NYSERDA's Floating Rate Monthly Demand Pollution Control Revenue Bonds (Rochester Gas and Electric Corporation Project), Series 1984. This obligation shall be deemed satisfied to the extent of the funds, if any, drawn on or before October 15, 1994 under an irrevocable Letter of Credit issued by Irving Trust Company. The interest rate on this note for each monthly interest payment period will be based on the evaluation of the yields of short term tax-exempt securities at par having the same credit rating as said Series 1984 Bonds. The average interest rate was 5.22% for 1988, 5.04% for 1987 and 5.08% for 1986.

The $40.2 million Promissory Note was issued in connection with NYSERDA's Adjustable Rate Pollution Control Revenue Bonds (Rochester Gas and Electric Corporation Project), Series 1985. This obligation shall be deemed satisfied to the extent of funds, if any, drawn on or before November 30, 1990 under an irrevocable Letter of Credit issued by Westpac Banking Corporation. This Promissory Note bore interest at 6½% per annum through November 14, 1988. The interest rate was adjusted to 5.90% effective November 15, 1988 through November 14, 1989 and will continue to be adjusted annually.

The $50.0 million Promissory Note was issued in connection with NYSERDA's Adjustable Rate Pollution Control Revenue Bonds (Rochester Gas and Electric Corporation Project), Series 1987. This obligation shall be deemed satisfied to the extent of funds, if any, drawn on or before July 31, 1992 under an irrevocable Letter of Credit issued by Citibank, N.A. This Promissory Note will bear interest at 5⅞% per annum through July 14, 1990. Thereafter, the interest rate will be adjusted annually.

Note 7. Preferred and Preference Stock

Type, by Order of Seniority	Par Value	Shares Authorized	Shares Outstanding
Preferred Stock (cumulative)	$100	2,000,000	970,000*
Preferred Stock (cumulative)	25	4,000,000	
Preference Stock	1	5,000,000	

See below for mandatory redemption requirements

≡ No shares of preferred or preference stock are reserved for employees, or for options, warrants, conversions, or other rights.

A. *Preferred Stock,* not subject to mandatory redemption:

%	Series	Shares Outstanding December 31, 1988	(Thousands) December 31 1988	1987	Redemption (per share)#
4	F	120,000	$12,000	$12,000	$105
4.10	H	80,000	8,000	8,000	101
4¾	I	60,000	6,000	6,000	101
4.10	J	50,000	5,000	5,000	102.5
4.95	K	60,000	6,000	6,000	102
4.55	M	100,000	10,000	10,000	101
7.50	N	200,000	20,000	20,000	102
Total		670,000	$67,000	$67,000	

#May be redeemed at any time at the option of the Company on 30 days minimum notice, plus accrued dividends in all cases.

B. *Preferred Stock,* subject to mandatory redemption:

%	Series	Shares Outstanding December 31, 1988	(Thousands) December 31 1988	1987	Redemption (per share)†
8.60	P			$21,609	$105.00 Before 9/1/89
8.25	R	300,000	$30,000	30,000	108.25 Before 3/1/92
		300,000	30,000	51,609	
Less: Redeemable within 1 year				812	
Total		300,000	$30,000	$50,797	

†Thereafter at lesser rates

≡ Mandatory redemption for Preferred Stock commenced on September 1, 1984 for Series P. The Company was required to redeem 8,125 shares per year, at $100 per share, by means of a sinking fund provision, with the noncumulative option to redeem not more than 8,125 additional shares per year on the same terms. On August 10, 1988, the Company purchased in an open market transaction and subsequently cancelled 16,732 shares of Series P Preferred Stock. On September 1, 1988, the Company called for redemption and subsequently cancelled 16,250 shares of Series P Preferred Stock, which satisfied the sinking fund requirement due September 1, 1988, and exercised its option to redeem additional shares. On December 1, 1988 all outstanding shares of Series P were called for redemption and subsequently cancelled. Mandatory redemption of 60,000 shares per year commences on March 1, 1993 for Series R. In the event the Company should be in arrears in the sinking fund requirement, the Company may not redeem or pay dividends on any stock subordinate to the Preferred Stock.

Note 8. Common Stock

At December 31, 1988, there were 35,000,000 shares of $5 par value Common Stock authorized, of which 30,785,811 were outstanding. There were 472,157 shares of Common Stock reserved and unissued under the Automatic Dividend Reinvestment and Stock Purchase Plan. No shares of Common Stock are reserved for options, warrants, conversions, or other rights. Net gains or losses resulting from the reacquisition of certain issues of Preferred Stock to satisfy sinking fund requirements (see Note 7) are shown as Reacquired Capital Stock.

Common Stock:

	Per Share	Shares Outstanding	Amount (Thousands)
Balance, January 1, 1986		28,496,809	$461,078
Automatic Dividend Reinvestment and Stock Purchase Plan	22.713–28.238	669,057	16,747
ESOP*	26.200	15,267	400
Savings Plus Plan	22.499–28.810	65,954	1,680
Capital Stock Expense			(166)
Reacquired Capital Stock			(35)
Balance, December 31, 1986		29,247,087	$479,704
Automatic Dividend Reinvestment and Stock Purchase Plan	15.175–24.750	760,986	14,132
ESOP*	23.970	17,939	430
Savings Plus Plan	14.499–24.874	95,363	1,706
Capital Stock Expense			(1,993)
Reacquired Capital Stock			39
Balance, December 31, 1987		30,121,375	$494,018
Automatic Dividend Reinvestment and Stock Purchase Plan	15.963–18.013	619,172	10,440
Savings Plus Plan	16.000–17.188	45,264	749
Capital Stock Expense			8
Reacquired Capital Stock			(308)
Balance, December 31, 1988		30,785,811	$504,907

**Employee Stock Ownership Plan*

Note 9. Short Term Debt

The Company had no outstanding short term debt at December 31, 1988 or December 31, 1987 and there were no borrowings in the calendar year 1988. The weighted average interest rates for borrowings in 1987 were 6.58% for short term notes and 6.25% for commercial paper.

On December 1, 1988 the Company renewed its $90 million revolving credit facility for a period of three years. Commitment fees related to this facility amounted to $322,000 in 1988 and $341,000 in 1987.

The Company's Charter provides that unsecured debt may not exceed 15 percent of the Company's total capitalization (excluding unsecured debt). As of December 31, 1988, the Company would be able to incur $6 million of unsecured debt under this provision. In order to be able to use its revolving credit agreement, the Company has created a subordinate mortgage which secures borrowings under its revolving credit agreement that might otherwise be restricted by this provision of the Company's Charter.

Note 10. Nine Mile Point Nuclear Plant

Nine Mile Point Nuclear Plant Unit No. 2 (Unit 2), a nuclear generating unit in Oswego County, New York, with an electrical capability of 1,080 megawatts, was completed and entered commercial service in Spring 1988. Niagara Mohawk Power Corporation (Niagara) is operating Unit 2 on behalf of all owner co-tenants pursuant to a full power operating license which the Nuclear Regulatory Commission (NRC) issued on July 2, 1987 for a 40-year term beginning October 31, 1986. Under the Basic Agreement entered into in September 1975, ownership, output, and cost of the project are shared by five co-tenants: the Company (14%), Niagara (41%), Long Island Lighting Company (LILCO) (18%), New York State Electric & Gas Corporation (18%) and Central Hudson Gas & Electric Corporation (9%).

The NRC advised Niagara on December 20, 1988, following their senior managers' biannual performance review of NRC-licensed nuclear power plants, that Unit 2 now warrants close monitoring by the NRC. Plants in this category have been identified as having weaknesses that warrant increased NRC attention. This conclusion was based on an NRC assessment of Unit 2's overall performance during its first year of operation. Nine Mile Point Nuclear Plant Unit No. 1 (Unit 1), an adjoining facility entirely owned and operated by Niagara, had been categorized in June 1988 as requiring close monitoring by the NRC. In its December 1988 evaluation, the NRC indicated that increased licensee and NRC management attention is needed to ensure that performance improvement is achieved for both units.

Unit 2 underwent an outage for planned maintenance and inspection which began October 1, 1988 and was still in progress in late January 1989. Niagara advises that the outage will continue until mid-February 1989, delaying until late February the unit's return to full power. The extension of the current outage's duration, particularly in the wake of the NRC's action noted above, heightens certain regulatory uncertainties facing the Company. The NRC's monitoring of plant conditions and the progress of outage work could lead it to require—as it has elsewhere—additional commitments of time and effort that would preclude a near-term restart. In addition, the PSC has initiated proceedings to review outages which extend beyond planned duration and may consider disallowance of some or all outage-related replacement power costs. Niagara has advised the Company that it does not believe the Unit 2 outage has been imprudently extended but is unable to predict whether the PSC will institute such a proceeding. Assuming there is not a substantial further extension, the Company believes the present outage will not have a material effect on its financial condition.

With the completion of construction and commencement of commercial operation, Niagara is preparing final cost figures for Unit 2. Its most recent estimate, announced in January 1988, was $6.120 billion, excluding nuclear fuel. Adding approximately $413 million of prepaid financing charges arising from the inclusion of construction work in progress in the rate bases of certain co-tenants, that sum is equivalent to a total Unit 2 cost of $6.533 billion. The Company's estimated share of that $6.533 billion total Unit 2 cost, including its applicable share of prepaid financing costs, would be approximately $951 million ($591 million of construction costs, $258 million of Allowance for Funds Used During Construction [AFUDC] and $102 million of prepaid financing costs). At December 31, 1988, excluding the adoption of a new accounting standard for the reporting of disallowed costs of recently completed plants (discussed below), the Company had incurred construction-related costs of $929 million ($588 million of construction costs, $245 million of AFUDC and $96 million of prepaid financing costs).

Certain of those costs, however, were disallowed for ratemaking purposes. In October 1986, the PSC approved a settlement (the "Settlement") with the co-tenants of its proceeding to inquire into the prudence of costs incurred for the construction of Unit 2. The Settlement provided that, whatever the final construction cost of Unit 2, the aggregate amount allowed in the co-tenant rate bases would be $4.16 billion, reduced by prepaid financing costs. It also barred suits among the co-tenants based on Unit 2 design, engineering and construction. In order to gain its four co-tenants' concurrence to limiting the aggregate rate base allowance for Unit 2 to the $4.16 billion level, Niagara undertook to reimburse each of them for its proportionate share of the difference between that figure and one of $4.45 billion to which the PSC Staff and all co-tenants had earlier agreed. In September 1988, Niagara paid the Company $40.6 million in connection with that undertaking.

In a series of rate orders preceding commercial operation of Unit 2, the PSC permitted most of the Company's $485 million allowed investment (its 14% share of $4.16 billion, or $582 million, less prepaid financing charges estimated at $96 million) to be reflected in its rates. During 1988, the PSC fixed April 5, 1988 as the Unit 2 commercial operation date for Niagara and LILCO, but it has not yet taken formal action on the subject with respect to the rates and accounts of the Company. The Company's rate case settlement, which the PSC approved on July 20, 1988, utilized a hypothetical date of April 15, 1988 for Unit 2 commercial operation, but contemplated that an actual commercial operation date would be separately adopted. PSC confirmation of Unit 2 commercial operation as of April 5, 1988, as expected, would decrease the Company's write-off, whereas selection of a date later than the Company's previously assumed mid-May commercial operation date would require an additional write-off of approximately $6 million (net of tax) each month. In addition, resolution of the disputed items discussed below could result in additional adjustments to the Company's allowable investment in rate base.

Despite the Settlement and the PSC October 1986 order approving it, the co-tenants and PSC Staff have disagreed on its implementation and interpretation in several separate proceedings. In one proceeding stemming from a Niagara rate case the PSC disallowed costs for certain common facilities and certain other costs the co-tenants considered outside the scope of the Settlement. The Company's investment in these items at project completion is estimated to be $20 million. The PSC also decided that the tax benefits associated with the disallowance should be calculated on a discounted present value basis, utilizing a 34% tax rate rather than a 46% tax rate proposed by the co-tenants. The Company, in its 1987 write-offs (discussed below), did not recognize the effect of discounting in its determination of the Federal income tax benefits applicable

(Note 10 continued on page 30)

(Continued from page 29)

to the disallowance since the nominal tax benefits at the 34% rate will be ultimately recovered for the benefit of the shareholder. However, the PSC did discount these tax benefits in determining the regulatory disallowance in its June 1987 and July 1988 decisions. Thus, the regulatory disallowance was approximately $19 million greater than the Company has recognized for financial reporting purposes. This difference in regulatory treatment will, all other things being equal, result in a reported return on equity which will initially be less than the PSC authorized return on equity and which will be eliminated over the 10-year tax life of Unit 2. The PSC also determined that the entire amount of disallowed costs will be recognized as a write-off to common equity for rate-making purposes. On July 10, 1987, the co-tenants commenced an action in State Supreme Court, Albany County, seeking review of the PSC decision on the settlement implementation issues. In August 1987, the case was transferred to the Appellate Division, Third Department, and is pending.

Other parties are also challenging the PSC's October 1986 order approving the Settlement. That appeal has also been transferred to the Appellate Division, Third Department, of State Supreme Court. Failure of the Settlement order to survive judicial challenge could result in the resumption of the PSC inquiry into the prudence of Unit 2 construction costs. It could also precipitate reinstatement of earlier PSC orders, superseded by the Settlement, which had adopted an incentive plan that limits rate recovery to 80% of those revenue requirements necessary to support Unit 2 capital costs exceeding $4.6 billion and then imposed a $5.4 billion cost cap on prudently incurred Unit 2 costs eligible for recovery through rates.

In September 1987, the Company adopted SFAS-90 and recognized a loss from the disallowance arising from the Settlement. In adopting SFAS-90, the Company presented the cumulative effect of the accounting change prior to January 1, 1987 in the Statement of Income and did not restate previously issued annual financial statements. The disallowance was comprised of:

		(Dollars in Millions)
Cumulative Effect of Accounting Change		$258
Less—Related Federal Income Tax Benefits		(65)
Net Effect Prior to January 1, 1987		193
AFUDC Accrued in 1987 on Disallowed Project Costs		22
Additional Disallowed Plant Costs Recognized in 1987	$ 56	
Less—Related Federal Income Tax Benefits	(9)	
		47
Net Effect in 1987		69
Net Disallowance		$262

The computation of the net disallowance as shown above was as follows:

		(Dollars in Millions)
Company Share of Total Plant Costs Based Upon Niagara's January 1988 Cost Estimate of $6.533 Billion including Prepaid Financing Charges and Adjusted for a Commercial Operation Date of mid-May 1988:		
Plant Costs	$591	
AFUDC	258	
Prepaid Financing Costs	102	
		$951
Common Facilities and Unshared Costs which the Company Considers Outside the Scope of the Settlement and Which Are Being Litigated		20
Total Investment		971
Settlement Allowance Comprised of:		
Plant Costs	480	
Prepaid Financing Costs	102	
		582
Amount Disallowed		389
Less—Payment from Niagara Mohawk		(41)
—Federal Income Tax Benefits		(74)
—AFUDC		(12)
Net Disallowance		$262

Earnings information for 1988 as reported and for 1987 and 1986 modified to exclude the write-off and applicable AFUDC is as follows:

	December 31, 1988	1987	1986
Earnings Applicable to Common Stock (000's)	$68,766	$63,042	$67,161
Weighted average number of shares (000's)	30,513	29,728	28,927
Earnings per Common Share	$2.25	$2.12	$2.32

In subsequent rate cases of some of the co-tenants, the Staff of the PSC has argued that certain post-in-service capital additions for Unit 2, estimated at $13 million for the Company, should be considered as falling under the scope of the Settlement cap and should not be afforded rate base treatment. The co-tenants disagree with the Staff's interpretation and vigorously oppose it. The settlement of the Niagara rate case, as well as that of the Company, contemplated a proceeding late in 1988 to examine on a single record these and similarly disputed amounts. This proceeding is now expected to begin following the conclusion of the current Unit 2 outage. The Company is unable to predict what position the PSC will ultimately adopt, and when and how much of these capital additions, if any, may have to be written off.

In an action stemming from a delay in Unit 2's testing and power ascension schedule occasioned by defects in the reactor's main steam isolation valves, the co-tenants in April 1987 commenced a lawsuit against three companies involved in the furnishing of that equipment. On August 1, 1988, the co-tenants commenced a second lawsuit, this one against both the firm furnishing architect-engineering and construction-management services and a company which fabricated and erected piping for Unit 2. This second suit seeks damages arising from the breach of certain obligations in the contractual arrangements with the defendants, which actions led to redesign, reconstruction and higher cost for the completed work. The parties are currently engaged in discovery procedures in both lawsuits. The Company cannot predict whether these suits will be successful or the amount of damages, if any, which may be recovered.

On January 26, 1989 the co-tenants entered into an agreement with General Electric Company (GE) relating to certain disputes which arose in connection with the Nuclear Steam Supply System (NSSS) portion of the construction of Unit 2, providing for settlement, mutual releases, and confidentiality of the specific elements of the agreement. The agreement provides that GE will supply certain goods and services to the co-tenants over a period of years without cost or at a reduced cost. Among other things, GE will supply engineering services which will improve Unit 2's technical specifications and which may ultimately result in the increased capacity of Unit 2; software designed to help avoid unplanned outages; other goods and services in support of Unit 2; and other goods and services relating to turbine upgrading and maintenance at co-tenants' generating facilities.

GE will receive indemnification from the co-tenants against any future judgments against GE brought by other Unit 2 contractors related to the NSSS portion of the construction of Unit 2, to the extent such judgments result from successful co-tenant claims against the contractors, and also indemnification for a portion of certain legal fees which GE may incur.

The present value of the goods and services will be recorded as an asset on the Company's balance sheet in 1989 with an offsetting deferred credit also being recorded, pending resolution of the rate treatment of the Settlement. While the Company does not believe the current treatment of the Settlement is material, the Company regards this as a favorable settlement. No part of the Settlement will be included in income pending PSC concurrence with the co-tenants' proposed accounting for such settlement and related expenses.

The directors of the Company in Fall 1986 received a demand letter, from a lawyer purporting to represent two shareholders of the Company, threatening to bring a shareholders' derivative action on behalf of the Company. The letter demanded that the directors take legal action against officers and directors responsible for what it alleged are losses sustained by the Company because of its investment in, and purported mismanagement of, the Unit 2 project. The Secretary of the Company responded to this letter and to a follow-up one by stating that the Board did not believe that, under then current circumstances, any further investigation into the demands was warranted and requesting a statement of any specific facts believed to require action. Neither the directors nor the Company officers have received further communications from this party on this matter in some two years, but the same firm represents certain shareholders of Niagara in derivative litigation commenced against that company's present and former officers and directors in May 1988. That suit seeks, in addition to the costs of the litigation itself, damages allegedly sustained by Niagara shareholders both from defendants' mismanagement of construction of Unit 2, and resulting disallowance imposed in settlement with the PSC, and from their concealment and fraud in failing to disclose such mismanagement. The Company is unable to predict whether the threats and demands received by it will lead to litigation similar to that in which Niagara is involved.

One of the co-tenant owners, LILCO, continues to experience governmental pressures, financial problems and other difficulties that could adversely affect its interest in Unit 2. State legislation enacted in 1986 created a public authority for the express purpose of taking over LILCO and, among other things, disposing of its interest in Unit 2. In mid-1988, LILCO and various parties opposing its efforts to license and operate the Shoreham Nuclear Plant reached a settlement which, had it gone into effect, would have ended the threat of LILCO takeover and attendant disposition of Unit 2. While certain conditions prerequisite to the Settlement's effectiveness were met, others were not and its status remains uncertain. LILCO is understood to be paying its share of ongoing Unit 2 expenses and receiving its entitlement to power. There is no immediate indication that will change, but LILCO's weakened financial condition and other difficulties impeding resolution of the public takeover threat leave uncertain its longer-term participation in the Unit 2 co-tenancy.

Note 11. Commitments and Other Matters

Capital Expenditures. The Company's 1989 construction expenditures program involves an estimated expenditure of $125 million, including $4 million of AFUDC. The Company has entered into certain commitments for purchase of materials and equipment in connection with that program.

Nine Mile Point Nuclear Plant. See Note 10.

Nuclear Plant Decommissioning. Under accounting procedures periodically reviewed by the PSC, the Company has been collecting in its electric rates amounts for the eventual decommissioning of its Ginna plant and, most recently, for its share of the decommissioning of Nine Mile Point Unit 2. In June 1988, the NRC issued new regulations establishing criteria for various facets of decommissioning including acceptable alternative methods, planning, funding and environmental review. The Company will comply with the NRC final rule by June 1990, submitting a funding plan and establishing an external decommissioning trust fund. To the extent that the NRC funding requirement is greater than the corresponding decommissioning costs allowed in rates by the PSC, the Company may be required to make deposits of the greater amount and will seek recovery in rates. The Company is not presently in a position to estimate the cost impact of any such difference or anticipate what actions the PSC will pursue in this matter.

Insurance. The Company is a member of Nuclear Electric Insurance Limited, which provides insurance coverage for the cost of replacement power during certain prolonged accidental outages of nuclear generating units and coverage for property losses in excess of $500 million at nuclear generating units. If an insuring program's losses exceeded its other resources available to pay claims, the Company could be subject to maximum assessments in any one policy year of approximately $2.5 million and $8.0 million in the event of losses under the replacement power and property damage coverages, respectively.

On August 22, 1988 the President signed into law the Price-Anderson Amendments Act of 1988 (the "Amendments"), legislation which significantly increased liability limits under the Price-Anderson Act, extended its effectiveness until the year 2002, and modified it in other respects. Under the legislation, the public liability limit with respect to a nuclear accident at a licensed reactor increased to approximately $7.3 billion. The difference between that amount and the amount of liability insurance currently available to the Company from commercial sources would continue to be funded by retrospective assessments, increased in amount by the 1988 legislation to $63 million per licensed facility for each nuclear incident, payable at a rate not to exceed $10 million per year. Those assessments are subject to periodic inflation-indexing and to a 5% surcharge if funds prove insufficient to pay claims. The Company's interests in two nuclear units could thus expose it to a potential payment for each accident of $71.8 million (inflation-indexed) through retrospective assessments of $11.4 million per year in the event of a sufficiently serious nuclear accident at its own or another U.S. commercial nuclear reactor. The Amendments also provide, among other things, that insurance and indemnity will cover precautionary evacuations whether or not a nuclear incident actually occurs, that Presidential compensation plans may provide coverage over and above that afforded under the Price-Anderson Act, and that a Presidential commission will study certain compensation issues which arose during consideration of the Amendments, notably coverage for latent illnesses attributable to an accident.

Effective January 1, 1988, coverage for claims alleging radiation-induced injuries to some workers at nuclear reactor sites was removed from the nuclear liability insurance policies purchased by the Company. Coverage for workers first engaged in nuclear-related employment at a nuclear site prior to January 1, 1988 continues to be provided under the existing nuclear liability insurance policies. Those workers first employed at a nuclear facility after January 1, 1988 are covered under a new, industry-wide insurance program. This new program contains a retrospective premium assessment feature whereby participants in the program could be assessed to pay incurred losses that exceed the program's reserves. Under the plan as currently established, the Company could be assessed a maximum of $2.6 million over the life of the insurance coverage.

Gas Cost Recovery. Throughout the late 1970's and early 1980's, many interstate natural gas pipelines signed long-term gas sales contracts with producers under which the pipelines were obligated to take delivery of a specified percentage of maximum contract volumes of natural gas or, if such quantities were not taken, to pay for them ("take-or-pay"). As a result of falling oil prices and a general trend towards energy conservation, many pipelines subsequently experienced a significant reduction in sales, leading to substantial take-or-pay liability to their producers. The Federal Energy Regulatory Commission (FERC), in response to this industry-wide problem, is allowing an interstate pipeline to pass through to its customers, including downstream pipelines and local gas distribution companies, between 25% and 50% of the pipeline's take-or-pay costs.

After receiving comments, the PSC appears to have concluded, in an order issued in October 1988, that it could deny recovery of pipeline take-or-pay costs billed by an interstate pipeline supplier and paid by a distribution company. No PSC response had been received on the Company's petition for reconsideration of that point as of mid-January 1989. The PSC has scheduled hearings to determine whether distribution companies should be required to absorb some portion of such take-or-pay costs and how that portion recoverable from ratepayers should be allocated among them. Staff of the PSC and the Company have entered into an interim settlement which would permit the Company to recover from ratepayers 65% of the take-or-pay costs during the continuation of the PSC proceeding but other parties to the proceeding oppose this interim settlement and the PSC had not acted on it as of mid-January 1989. At December 31, 1988 the Company had deferred $1.1 million of billed take-or-pay charges.

The Company is unable to predict whether the PSC will require that it absorb some portion of the take-or-pay costs billed by its interstate pipeline supplier or, if the PSC does so require, whether that action will survive judicial review. Moreover, because several pipelines currently have pending before FERC proposals for the recovery of take-or-pay costs, the Company is unable to estimate at this time its overall exposure to such costs.

PSC Fuels Audit. The Company was notified by the PSC in December 1988 that its Utility Operational Audit Section would conduct an audit of the Company's fuel procurement practices. The audit began in January 1989 with a series of informational requests, an introductory meeting of the PSC Audit Section with responsible Company employees for orientation and explanation of procedures, and initial identification of key Company files. The PSC personnel have indicated an interest in reviewing the Company's procurement of coal, oil and nuclear fuel. Their work, which is expected to include visits to Company generating stations as well as to mines, laboratories and other facilities involved in the procurement function, may take as long as a year to complete. The Company expects to be given an opportunity to comment on any findings and recommendations stemming from the audit. Similar audits at other New York utilities have produced recommendations that the PSC require refunds of a portion of rates charged to customers for fuel costs. The Company believes its fuel procurement practices to be sound, but is not able to predict what the PSC Audit Section may recommend or what action the PSC may take.

Environmental Matters. Operations of the Company's facilities are subject to various Federal, state and local environmental standards.

In 1985, the New York State Department of Environmental Conservation (NYSDEC) identified property in the vicinity of the Lower Falls of the Genesee River in Rochester as an inactive hazardous waste disposal site. The NYSDEC conducted an investigation with which the Company as an owner of a portion of the property cooperated and, in March 1988, released a report entitled "Expanded Phase I Investigation—Genesee River Gorge (Lower Falls)". That report includes an assessment of the adequacy of available data, makes recommendations for additional phased investigations and identifies property owners. The Company is included in the list of property owners; however, a list of potentially responsible parties has not yet been completed. The site has been assigned Classification 2, "significant threat to the public health or environment—action required," in the NYSDEC's registry of inactive waste sites. Cleanup of certain areas of the site may eventually be ordered by NYSDEC. At another location along the River where the Company owns property, a boring taken for a sewer system project in Fall 1988 showed a layer containing a black viscous material. There was no indication that the material is migrating and it does not appear to be linked to the Lower Falls site. The find was reported to the NYSDEC, but the Company is not aware of any investigation being conducted by the agency.

If the NYSDEC requires remediation of these sites by virtue of ownership and/or past site disposal activity, the Company may be fully or partially responsible for the costs of investigation and any site remediation. The Company cannot at this time predict whether the NYSDEC will investigate the material from the boring, what outcome will be reached in the Lower Falls site investigation, and, with respect to either location, what future studies may be performed, what remediation measures may be directed and what share of any such activities the Company may be asked to assume.

Other Matters. The Company's contract with the federal Department of Energy (DOE) for nuclear fuel enrichment services assures provision of 70% of the Ginna Nuclear Plant's requirements throughout its service life or 30 years, whichever is less. No payment

(Note 11 continued on page 34)

(Continued from page 33)

obligation accrues unless such enrichment services are needed. The Company has secured the remaining 30% of its Ginna requirements under additional arrangements with DOE through 1989 and for the years 1991 through 1995; it is currently reviewing its options for the remainder of 1990 requirements. The annual cost of enrichment services utilized for the three most recent years and that estimated for the next seven years (priced at the most current rate) are as follows:

1986	$5,400,000
1987	4,700,000
1988	5,300,000
1989–1990	3,700,000
1991–1995	5,500,000

There have been no significant developments in nine- and ten-year old suits brought in various courts against the Company seeking an aggregate of $34.5 million in compensatory and $64 million in punitive damages for what are alleged to be personal injuries sustained through radiation exposure in 1974 at the Company's Ginna Nuclear Plant. The Company's initial assessment led it to believe that plaintiffs would not prevail on the merits. The cases have been generally inactive and no discovery has taken place in any of them. The Company's insurer disclaimed coverage for punitive damages.

Related litigation seeking substantial compensatory and punitive damages, brought by some of the plaintiffs against the Company over an interoffice memorandum, has been concluded successfully with no payment by the Company or its insurer.

Report of Independent Accountants

Price Waterhouse

1900 Lincoln First Tower
Rochester, New York 14604
January 26, 1989

To the Shareholders and Board of Directors of
Rochester Gas and Electric Corporation

In our opinion, the accompanying balance sheets and the related statements of income, retained earnings and cash flows present fairly, in all material respects, the financial position of Rochester Gas and Electric Corporation at December 31, 1988 and 1987, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1988, in conformity with generally accepted accounting principles. 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 of these statements in accordance with generally accepted auditing standards which 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

As described in Note 10, the Company adopted in 1987 Statement of Financial Accounting Standards No. 90 "Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs." The adoption of this Statement resulted in the disallowed portion of the Company's investment in the Nine Mile Point Nuclear Plant Unit No. 2 (Unit) being recognized as a loss in the 1987 financial statements.

As a result of continuing uncertainties with respect to the Unit discussed in Note 10, the Company is unable to predict whether further regulatory actions by the New York State Public Service Commission with respect to its investment in the Unit will have, in the aggregate, a material effect on its financial position or results of operations. Accordingly, no provision for any additional loss that may result upon resolution of these uncertainties has been made in the accompanying financial statements.

Price Waterhouse

Common Stock and Dividends

Dividend Policy

The Company has paid cash dividends quarterly on its Common Stock without interruption since it became publicly held in 1949. The Company expects to continue this policy, although the level of future dividend payments is necessarily dependent on the Company's future earnings, its cash flow and additional factors discussed under the heading Earnings/Summary presented in Management's Discussion and Analysis of Financial Condition and Results of Operations.

Quarterly dividends on Common Stock are generally paid on the twenty-fifth day of January, April, July and October. In January 1989, the Company paid a cash dividend of $.375 per share on its Common Stock. Quarterly dividends have been paid at this rate since October 1987, when the dividend was reduced from a quarterly rate of $.55 per share. The October 1987 reduction resulted from the Company's analysis of its 1987 rate decision, wherein the PSC recognized the disallowance of certain Nine Mile Two plant costs for rate-making purposes. The Company's analysis indicated that the rate increase granted was not adequate to maintain the quarterly Common Stock dividend at the prior level of $.55 per share.

The Company's Certificate of Incorporation provides for the payment of dividends on Preferred Stock and Common Stock out of the surplus net profits (retained earnings) of the Company. The Company presently intends to establish a retained earnings base at least equal to its annual dividend requirement for both Preferred Stock and Common Stock before considering an increase in the Common Stock dividend rate above the current quarterly rate.

Automatic Dividend Reinvestment and Stock Purchase Plan

Common Stock shareholders may have the dividends on all, or any designated number, of their shares automatically reinvested in additional shares of Common Stock by participating in the Company's Automatic Dividend Reinvestment and Stock Purchase Plan. Participants may also make optional cash payments of up to $5,000 each month to acquire additional shares, whether or not they reinvest their dividends. Optional cash payments need not be made on a monthly or other recurring basis. Participants may change their method of participation, withdraw from the Plan or re-enroll as often as they wish. More information on the automatic reinvestment of dividends may be obtained by writing to the Agent, Chase Lincoln First Bank, N.A., Corporate Agency Department, Post Office Box 1507, Rochester, New York 14603 or by calling the Agent at (716) 258-5854.

Tax Status of Cash Dividends

Cash dividends paid in 1988, 1987 and 1986 were 100 percent taxable for Federal income tax purposes.

Earnings and Dividends

	1988	1987	1986
Earnings per weighted average share			
Total	**$2.25**	$(5.95)	$3.33
Before cumulative effect of accounting change	**$2.25**	$ .54	$3.33
Number of shares (000's)			
Weighted average	**30,513**	29,728	28,927
Actual number at December 31	**30,786**	30,121	29,247
Number of shareholders at December 31	**41,834**	44,127	45,959
Cash dividends paid			
1st quarter	**$.375**	$ .55	$.55
2nd quarter	**.375**	.55	.55
3rd quarter	**.375**	.55	.55
4th quarter	**.375**	.375	.55

Common Stock Trading

Shares of the Company's Common Stock are traded on the New York Stock Exchange under the symbol "RGS".

	1988	1987	1986
Common Stock—Price Range			
High			
1st quarter	**17½**	25⅞	28
2nd quarter	**18¼**	19⅞	28¼
3rd quarter	**18¼**	18⅜	29⅞
4th quarter	**17⅞**	17¼	25⅜
Low			
1st quarter	**14¾**	19⅞	22⅜
2nd quarter	**15¾**	15⅝	24⅛
3rd quarter	**16⅜**	16¾	24¾
4th quarter	**16¾**	14¼	21¼

Shareholder Profile—December 31, 1988

Common Stock Shareholders	
Women	13,284
Men	12,031
Joint Accounts	10,585
Fiduciaries, Nominees, Others	5,934
Location	
United States, Except New York State	22,185
New York State, Except Franchise Area	7,163
Franchise Area	12,352
Foreign Countries	134
Shareholders Owning	
1–200 shares	22,479
201–500	11,322
501–1,000	4,839
Over 1,000	3,194

Selected Financial Data

Summary of Operations

(Thousands of Dollars) Year Ended December 31	1988	1987	1986	1985	1984	1983
Operating Revenues						
Electric	**$ 513,617**	$ 489,215	$466,496	$429,450	$416,856	$407,948
Gas	**230,395**	216,058	261,688	269,562	291,628	276,357
	744,012	705,273	728,184	699,012	708,484	684,305
Electric sales to other utilities	**29,966**	26,215	20,465	44,103	60,103	55,644
Total Operating Revenues	**773,978**	731,488	748,649	743,115	768,587	739,949
Operating Expenses						
Fuel Expenses						
Electric fuels	**64,767**	61,292	52,186	64,776	82,106	88,745
Purchased electricity	**30,299**	26,467	30,144	27,804	35,497	33,820
Gas purchased for resale	**128,774**	121,736	160,904	174,644	187,453	189,526
Total Fuel Expenses	**223,840**	209,495	243,234	267,224	305,056	312,091
Operating Revenues Less Fuel Expenses	**550,138**	521,993	505,415	475,891	463,531	427,858
Other Operating Expenses						
Operations excluding fuel expenses	**159,689**	159,170	148,340	129,273	131,670	132,032
Maintenance	**52,575**	46,124	44,767	42,518	41,013	39,418
Depreciation and Amortization	**69,703**	55,530	52,072	46,716	42,199	39,279
Taxes—local, state and other	**88,635**	82,869	84,590	81,983	83,013	80,118
Federal income tax—current	**20,363**	32,781	22,521	12,974	15,724	5,390
—deferred	**20,299**	23,144	37,304	44,978	41,885	32,794
Total Other Operating Expenses	**411,264**	399,618	389,594	358,442	355,504	329,031
Operating Income	**138,874**	122,375	115,821	117,449	108,027	98,827
Other Income and Deductions						
Allowance for other funds used during construction	**2,047**	5,030	32,828	38,393	33,782	25,697
Federal income tax	**1,683**	17,520	13,880	13,344	13,356	9,724
Disallowed project costs	**—**	(55,860)	—	—	—	—
Other, net	**6,901**	8,831	6,725	3,899	261	1,579
Total Other Income and Deductions	**10,631**	(24,479)	53,433	55,636	47,399	37,000
Income before Interest Charges	**149,505**	97,896	169,254	173,085	155,426	135,827
Interest Charges						
Long term debt	**72,270**	73,489	74,571	70,373	63,103	56,761
Short term debt	**—**	129	68	—	19	936
Other, net	**2,898**	2,685	2,074	2,227	2,464	2,048
Allowance for borrowed funds used during construction	**(1,777)**	(2,696)	(11,978)	(14,339)	(12,741)	(10,168)
Total Interest Charges	**73,391**	73,607	64,735	58,261	52,845	49,577
Income from Continuing Operations, Before Cumulative Effect of Accounting Change	**76,114**	24,289	104,519	114,824	102,581	86,250
Discontinued Steam Operations	**—**	—	—	(6,356)	1,037	(2)
Cumulative Effect for Years Prior to 1987 of Accounting Change for Disallowed Costs	**—**	(193,000)	—	—	—	—
Net Income (Loss)	**76,114**	(168,711)	104,519	108,468	103,618	86,248
Dividends on Preferred and Preference Stock, at required rates	**7,348**	8,147	8,058	9,467	12,213	10,515
Earnings (Loss) Applicable to Common Stock	**$ 68,766**	$(176,858)	$ 96,461	$ 99,001	$ 91,405	$ 75,733
Weighted Average Number of Shares Outstanding in Each Period, (000's)	**30,513**	29,728	28,927	27,641	25,101	23,389
Earnings (Loss) per Common Share—Total	**$2.25**	$(5.95)	$3.33	$3.58	$3.64	$3.23
Earnings (Loss) per Common Share—Continuing Operations	**$2.25**	$ .54	$3.33	$3.81	$3.60	$3.23
Cash Dividends Paid per Common Share	**$1.50**	$2.025	$2.20	$2.20	$2.04	$1.84

Condensed Balance Sheet

(Thousands of Dollars) At December 31	**1988**	1987	1986	1985	1984	1983
ASSETS						
Utility Plant	**$2,122,922**	$1,559,848	$1,531,019	$1,446,916	$1,394,375	$1,310,459
Less—Accumulated depreciation and amortization	**653,876**	586,840	571,022	532,947	489,938	449,807
	1,469,046	973,008	959,997	913,969	904,437	860,652
Construction work in progress	**41,044**	501,738	768,905	710,194	554,331	424,875
Net utility plant	**1,510,090**	1,474,746	1,728,902	1,624,163	1,458,768	1,285,527
Current Assets	**211,313**	184,309	141,222	144,217	151,042	135,403
Deferred Debits	**102,015**	131,526	114,340	82,092	64,269	75,927
Total Assets	**$1,823,418**	$1,790,581	$1,984,464	$1,850,472	$1,674,079	$1,496,857
CAPITALIZATION AND LIABILITIES						
Capitalization						
Long term debt	**$ 792,976**	$ 845,326	$ 773,082	$ 765,511	$ 678,018	$ 611,282
Preferred stock redeemable at option of Company	**67,000**	67,000	67,000	67,000	67,000	67,000
Preferred stock subject to mandatory redemption	**30,000**	50,797	43,485	45,922	47,562	49,187
Preference stock subject to repurchase						28,000
Common shareholders' equity						
Common stock	**504,907**	494,018	479,704	461,078	405,200	385,921
Retained earnings	**39,710**	17,617	249,505	216,795	179,676	153,142
Total common shareholders' equity	**544,617**	511,635	729,209	677,873	584,876	539,063
Total Capitalization	**1,434,593**	1,474,758	1,612,776	1,556,306	1,377,456	1,294,532
Long Term Liability—Department of Energy	**51,016**	47,773	44,950	42,214	39,084	35,363
Current Liabilities	**126,233**	90,504	118,348	98,270	131,108	81,602
Deferred Credits and Other Liabilities	**211,576**	177,546	208,390	153,682	126,431	85,360
Total Capitalization and Liabilities	**$1,823,418**	$1,790,581	$1,984,464	$1,850,472	$1,674,079	$1,496,857

Financial Data

At December 31	**1988**	1987	1986	1985	1984	1983
Capitalization Ratios* (percent)						
Long term debt	**56.8**	58.7	49.3	50.5	50.6	48.6
Preferred and preference stock	**6.5**	7.7	6.7	7.1	8.1	10.9
Common shareholders' equity	**36.7**	33.6	44.0	42.4	41.3	40.5
Total	**100.0**	100.0	100.0	100.0	100.0	100.0
Book Value per Common Share—Year End	**$17.69**	$16.98	$24.93	$23.79	$22.78	$22.09
Rate of Return on Average Common Equity (percent)	**12.68**	12.45**	13.38	14.93	16.01	14.97
Embedded Cost of Senior Capital (percent)						
Long term debt	**8.71**	8.90	9.36	9.88	9.91	10.07
Preferred stock	**6.72**	7.09	7.20	7.27	7.37	7.37
Effective Federal Income Tax Rate (percent)	**33.9**	61.3	30.5	28.0	30.1	24.8
Depreciation Rate (percent)—Electric	**3.56**	3.50	3.50	3.40	3.30	3.23
—Gas	**2.96**	2.98	2.99	2.98	3.12	2.96
Interest Coverages***						
Before federal income taxes (incld. AFUDC)	**2.53**	2.55	2.96	3.08	3.26	2.91
(excld. AFUDC)	**2.48**	2.45	2.38	2.35	2.55	2.31
After federal income taxes (incld. AFUDC)	**2.01**	1.93	2.36	2.49	2.58	2.44
(excld. AFUDC)	**1.96**	1.83	1.78	1.77	1.87	1.84

**Includes Company's long term liability to the Department of Energy*

***Excludes disallowed Nine Mile Two plant costs written off in 1987*

****AFUDC included in interest coverages prior to 1987 has not been restated to reflect the disallowance of certain Nine Mile Two plant costs recognized by the Company in 1987*

Electric Department Statistics

Year Ended December 31	1988	1987	1986	1985	1984	1983
Electric Revenue (000's)						
Residential	**$188,451**	$178,933	$166,664	$155,193	$147,500	$143,455
Commercial	**149,663**	146,138	137,077	122,292	118,628	118,610
Industrial	**120,490**	118,479	116,321	110,135	109,052	103,598
Other	**55,013**	45,665	46,434	41,830	41,676	42,285
Electric revenue from our customers	**513,617**	489,215	456,496	429,450	416,856	407,948
Other electric utilities	**29,966**	26,215	20,465	44,103	60,103	55,644
Total electric revenue	**543,583**	515,430	486,961	473,553	476,959	463,592
Electric Expense (000's)						
Fuel used in electric generation	**64,767**	61,292	52,186	64,776	82,106	88,745
Purchased electricity	**30,299**	26,467	30,144	27,804	35,497	33,820
Other operation	**124,871**	26,320	113,497	96,194	97,612	100,412
Maintenance	**44,060**	37,641	36,573	35,013	33,535	32,444
Depreciation and Amortization	**60,444**	46,776	43,753	39,015	34,822	32,648
Taxes—local, state and other	**66,426**	61,504	61,314	58,867	59,215	57,931
Electric revenue deductions	**390,867**	360,000	337,467	321,669	342,787	346,000
Operating Income before Federal Income Tax	**152,716**	155,430	149,494	151,884	134,172	117,592
Federal income tax	**34,093**	48,788	52,051	52,068	47,410	34,339
Operating Income from Electric Operations (000's)	**$118,623**	$106,642	$ 97,443	$ 99,816	$ 86,762	$ 83,253
Electric Operating Ratio %	**48.6**	48.8	47.7	47.3	52.2	55.1
Electric Sales—KWH (000's)						
Residential	**2,051,808**	1,970,345	1,890,293	1,846,993	1,834,564	1,788,785
Commercial	**1,792,162**	1,732,939	1,657,606	1,591,670	1,539,662	1,491,736
Industrial	**1,869,417**	1,782,223	1,775,722	1,814,460	1,783,415	1,609,787
Other	**483,730**	463,256	452,756	452,142	452,189	462,089
Electric sales to our customers	**6,197,117**	5,948,763	5,776,377	5,705,265	5,609,830	5,352,397
Other electric utilities	**1,149,900**	1,047,654	925,318	1,404,504	1,554,392	1,370,239
Total electric sales	**7,347,017**	6,996,417	6,701,695	7,109,769	7,164,222	6,722,636
Electric Customers at December 31						
Residential	**290,037**	285,988	281,630	277,758	273,050	268,764
Commercial	**27,888**	27,383	26,865	26,184	25,432	24,998
Industrial	**1,392**	1,381	1,368	1,362	1,459	1,425
Other	**2,326**	2,281	2,266	2,254	2,249	2,151
Total electric customers	**321,643**	317,033	312,129	307,558	302,190	297,338
Electricity Generated and Purchased—KWH (000's)						
Fossil	**2,214,588**	1,877,922	1,491,167	2,211,246	2,285,761	2,431,144
Nuclear	**3,884,884**	3,793,021	3,603,116	3,613,104	3,143,923	3,027,160
Hydro	**169,002**	223,958	235,175	153,636	218,228	200,325
Pumped storage	**292,305**	246,925	237,663	240,375	205,760	226,612
Less energy for pumping	**(430,401)**	(387,546)	(353,735)	(373,537)	(311,710)	(342,853)
Other	**2,195**	4,554	1,850	4,354	3,846	3,111
Total generated—Net	**6,132,573**	5,758,834	5,215,236	5,849,178	5,545,808	5,545,499
Purchased	**1,705,755**	1,703,411	1,945,586	1,713,481	2,037,936	1,609,553
Total electric energy	**7,838,328**	7,462,245	7,160,822	7,562,659	7,583,744	7,155,052
Electric Generation Costs (000's)						
Fossil	**$ 65,274**	$ 59,695	$ 51,056	$ 71,898	$ 72,706	$ 80,909
Nuclear	**74,661**	58,965	56,136	49,772	50,020	45,904
Hydro	**2,772**	1,695	2,134	1,616	1,504	1,180
Other	**401**	465	274	776	362	431
Electric Department Fuel						
Fossil —Total BTU (million)	**23,425,796**	20,083,347	15,896,376	23,140,883	23,627,034	25,670,771
—Cents per million BTU	**201.40**	209.55	216.69	237.09	232.64	252.67
Nuclear—Total BTU (million)	**41,662,677**	40,538,534	38,660,500	39,034,016	34,225,538	33,020,145
—Cents per million BTU	**49.07**	52.30	48.49	46.85	50.67	57.38
System Net Capability—KW at December 31						
Fossil	**541,000**	541,000	510,000	587,000	587,000	605,000
Nuclear	**621,000**	470,000	470,000	470,000	470,000	470,000
Hydro	**47,000**	47,000	47,000	47,000	47,000	47,000
Other	**29,000**	29,000	29,000	29,000	29,000	29,000
Purchased	**360,000**	363,000	356,000	352,000	355,000	353,000
Total system net capability	**1,598,000**	1,450,000	1,412,000	1,485,000	1,488,000	1,504,000
Net Peak Load—KW	**1,275,000**	1,205,000	1,100,000	1,076,000	1,075,000	1,037,000
Annual Load Factor—Net %	**60.0**	60.8	64.7	65.4	63.9	63.9

Gas Department Statistics

Year Ended December 31	1988	1987	1986	1985	1984	1983
Gas Revenue (000's)						
Residential	**6,439**	$ 6,436	$ 7,694	$ 8,403	$ 8,924	$ 8,910
Residential spaceheating	**[illegible]0,383**	138,552	156,120	153,279	162,727	153,167
Commercial	**44,781**	43,311	52,653	53,568	56,518	53,636
Industrial	**9,859**	10,842	28,800	38,837	46,518	44,552
Municipal and other	**18,933**	16,917	16,421	15,475	16,941	16,092
Total gas revenue	**230,395**	216,058	261,688	269,562	291,628	276,357
Gas Expense (000's)						
Gas purchased for resale	**128,774**	121,736	160,904	174,644	187,453	189,526
Other operation	**34,818**	32,850	34,843	33,079	34,058	31,620
Maintenance	**8,515**	8,483	8,194	7,505	7,478	6,974
Depreciation	**9,259**	8,754	8,319	7,701	7,377	6,631
Taxes—local, state and other	**22,209**	21,365	23,276	23,116	23,798	22,187
Gas revenue deductions	**203,575**	193,188	235,536	246,045	260,164	256,938
Operating Income before Federal Income Tax	**26,820**	22,870	26,152	23,517	31,464	19,419
Federal income tax	**6,569**	7,137	7,774	5,884	10,199	3,845
Operating Income from Gas Operations (000's)	**$ 20,251**	$ 15,733	$ 18,378	$ 17,633	$ 21,265	$ 15,574
Gas Operating Ratio %	**74.7**	75.5	77.9	79.8	78.5	82.5
Gas Sales—Therms (000's)						
Residential	**10,374**	10,255	11,382	12,296	12,746	12,323
Residential spaceheating	**267,697**	244,655	253,101	244,593	252,518	232,380
Commercial	**86,413**	83,167	[illegible]2,864	93,283	95,427	88,501
Industrial	**20,174**	22,033	56,621	76,263	90,266	82,895
Municipal	**15,514**	17,985	23,405	[illegible]1,848	26,937	24,661
Total gas sales to our customers	**400,172**	378,095	437,373	451,283	477,894	440,760
Transportation of customer-owned gas	**83,594**	67,496	24,589	618	—	—
Total gas sold and transported	**483,766**	445,591	461,962	451,901	477,894	440,760
Gas Customers at December 31						
Residential	**24,139**	24,834	25,865	27,202	28,438	29,246
Residential spaceheating	**210,710**	206,458	201,227	196,035	191,192	187,071
Commercial	**17,213**	16,771	16,330	15,816	15,323	15,020
Industrial	**1,042**	1,035	1,015	1,029	1,019	977
Municipal	**1,039**	1,026	1,009	990	977	970
Total gas customers	**254,143**	250,124	245,446	241,072	236,949	233,284
Gas—Therms (000's)						
Purchased for resale	**408,044**	381,632	439,381	469,386	475,976	462,357
Other	**1,967**	2,317	5,996	14,943	18,039	16,479
Total gas available	**410,011**	383,949	445,377	484,329	494,015	478,836
Cost of gas per therm	**31.76¢**	32.51¢	35.82¢	37.53¢	38.52¢	40.51¢
Total Daily Capacity—Therms at December 31*	**4,485,000**	4,485,000	4,485,000	4,485,000	4,485,000	4,150,000
Maximum daily throughput—Therms	**3,744,500**	3,443,240	3,499,640	3,746,980	3,711,490	3,456,050
Degree Days (Customer Billing)						
For the period	**6,871**	6,439	6,742	6,412	6,784	6,305
Percent colder (warmer) than normal	**1.2**	(4.6)	1.3	(5.0)	1.1	(6.3)

*Method for determining daily capacity, based on current network analysis, reflects the maximum demand which the transmission system can accept without a deficiency

Interim Financial Data

In the opinion of the Company, the following quarterly information includes all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of the results of operations for such periods. The variations in operations reported on a quarterly basis are a result of the seasonal nature of the Company's business and the availability of the Company's Ginna Nuclear Plant. The cumulative effect of the accounting change related to the Nine Mile Two disallowed project costs and related write-offs during the year 1987 are discussed in Note 10 of the Notes to the Financial Statements.

	(Thousands)				
Quarter Ended	Operating Revenues	Operating Income	Net Income (Loss)	Earnings (Loss) on Common Stock	Earnings (Loss) Per Common Share (in dollars)
December 31, 1988	**$197,879**	**$26,454**	**$ 10,577**	**$ 9,071**	**$ .29**
September 30, 1988	**172,848**	**37,879**	**21,979**	**20,079**	**.65**
June 30, 1988	**166,615**	**28,396**	**12,517**	**10,546**	**.34**
March 31, 1988	**236,635**	**46,145**	**31,042**	**29,071**	**.96**
December 31, 1987	$177,764	$25,256	$ (9,771)	$ (11,742)	$ (.39)
September 30, 1987	165,281	32,272	20,268	18,297	.61
June 30, 1987	157,193	24,271	12,686	10,715	.36*
March 31, 1987	231,250	40,576	(191,894)	(194,128)	(6.60)*
December 31, 1986	$180,634	$23,433	$ 18,910	$ 16,926	$ .57
September 30, 1986	150,835	26,664	22,620	20,636	.71
June 30, 1986	162,991	24,539	23,130	21,085	.73
March 31, 1986	254,189	41,185	39,859	37,814	1.32

**Restated from published quarterly data. The cumulative effect of the accounting change ($193 million, net of Federal income tax benefits) has been reflected in the first quarter restatement. The first and second quarters reflect the discontinuance of AFUDC on the disallowed project costs. (See Note 10 of the Notes to the Financial Statements.)*

Directors and Officers

(As of January 1, 1989)

Board of Directors

Theodore J. Altier
Former Chairman of the Board and
Chief Executive Officer,
Altier & Sons Shoes, Inc.

Keith W. Amish
Former Vice Chairman of the Board,
Rochester Gas and Electric Corporation

William Balderston III
Chairman of the Board,
Chief Executive Officer and President,
Chase Lincoln First Bank, N.A.

Paul W. Briggs
Chairman of the Executive and
Finance Committee,
Rochester Gas and Electric Corporation

E. Kent Damon
Former Vice President and Secretary,
Xerox Corporation

Francis E. Drake, Jr.
Former Chairman of the Executive and
Finance Committee,
Rochester Gas and Electric Corporation

Natacha P. Dykman
Former Chairman of the Board of Trustees,
Center for Governmental
Research, Inc.

Walter A. Fallon
Former Chairman of the Board and
Chief Executive Officer,
Eastman Kodak Company

Roger W. Kober
President and Chief
Operating Officer,
Rochester Gas and Electric Corporation

Theodore L. Levinson
Former President and
Chief Executive Officer,
Star Supermarkets, Inc.

Constance M. Mitchell
Program Director,
Industrial Management Council of
Rochester, New York, Inc.

Cornelius J. Murphy
Senior Vice President and
General Manager,
Eastman Kodak Company

Arthur M. Richardson
President,
Richardson Capital Corporation

M. Richard Rose
President,
Rochester Institute of Technology

Harry G. Saddock
Chairman of the Board and
Chief Executive Officer,
Rochester Gas and Electric Corporation

William G. vonBerg
Executive Director,
Executive Service Corps of
Rochester, Inc.

Committees of the Board of Directors

Executive and Finance

Keith W. Amish
William Balderston III
Paul W. Briggs*
E. Kent Damon
Francis E. Drake, Jr.
Walter A. Fallon
Roger W. Kober
Arthur M. Richardson
Harry G. Saddock
William G. vonBerg

Audit

Paul W. Briggs
Natacha P. Dykman
Theodore L. Levinson
Constance M. Mitchell
Cornelius J. Murphy
M. Richard Rose
William G. vonBerg*

Compensation

William Balderston III
Paul W. Briggs
E. Kent Damon
Francis E. Drake, Jr.*
Walter A. Fallon
Cornelius J. Murphy
William G. vonBerg

Nominating

Theodore J. Altier
E. Kent Damon*
Natacha P. Dykman
Constance M. Mitchell
Arthur M. Richardson
Harry G. Saddock

**Chairman*

Officers

Harry G. Saddock
Chairman of the Board and
Chief Executive Officer
Age 59, Years of Service, 38

Roger W. Kober
President and Chief Operating Officer
Age 55, Years of Service, 2[illegible]

Robert C. Henderson
Senior Vice President,
Controller and Chief Financial Officer
Age 48, Years of Service, 25

David K. Laniak
Senior Vice President, Gas, Electric
Distribution and Corporate Planning
Age 53, Years of Service, 34

John W. Oberlies
Senior Vice President,
Customer and Administrative Services
Age 49, Years of Service, 27

John E. Arthur
Vice President,
Technical Projects
Age 59, Years of Service, 33

David C. Heiligman
Vice President,
Secretary and Treasurer
Age 48, Years of Service, 25

Howard E. Rowley
Vice President,
Gas and Transportation
Age 61, Years of Service, 40

Richard J. Rudman
Vice President,
Electric Transmission and Distribution
Age 61, Years of Service, 43

Wilfred J. Schrouder, Jr.
Vice President,
Employee Relations and Public Affairs
Age 47, Years of Service, 26

Robert E. Smith
Vice President,
Production and Engineering
Age 51, Years of Service, 29

Daniel J. Baier
Assistant Controller
Age 42, Years of Service, 5

John M. Kuebel
Auditor
Age 53, Years of Service, 24

Alan A. Lohrmann
Assistant Treasurer
Age 49, Years of Service, 27

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