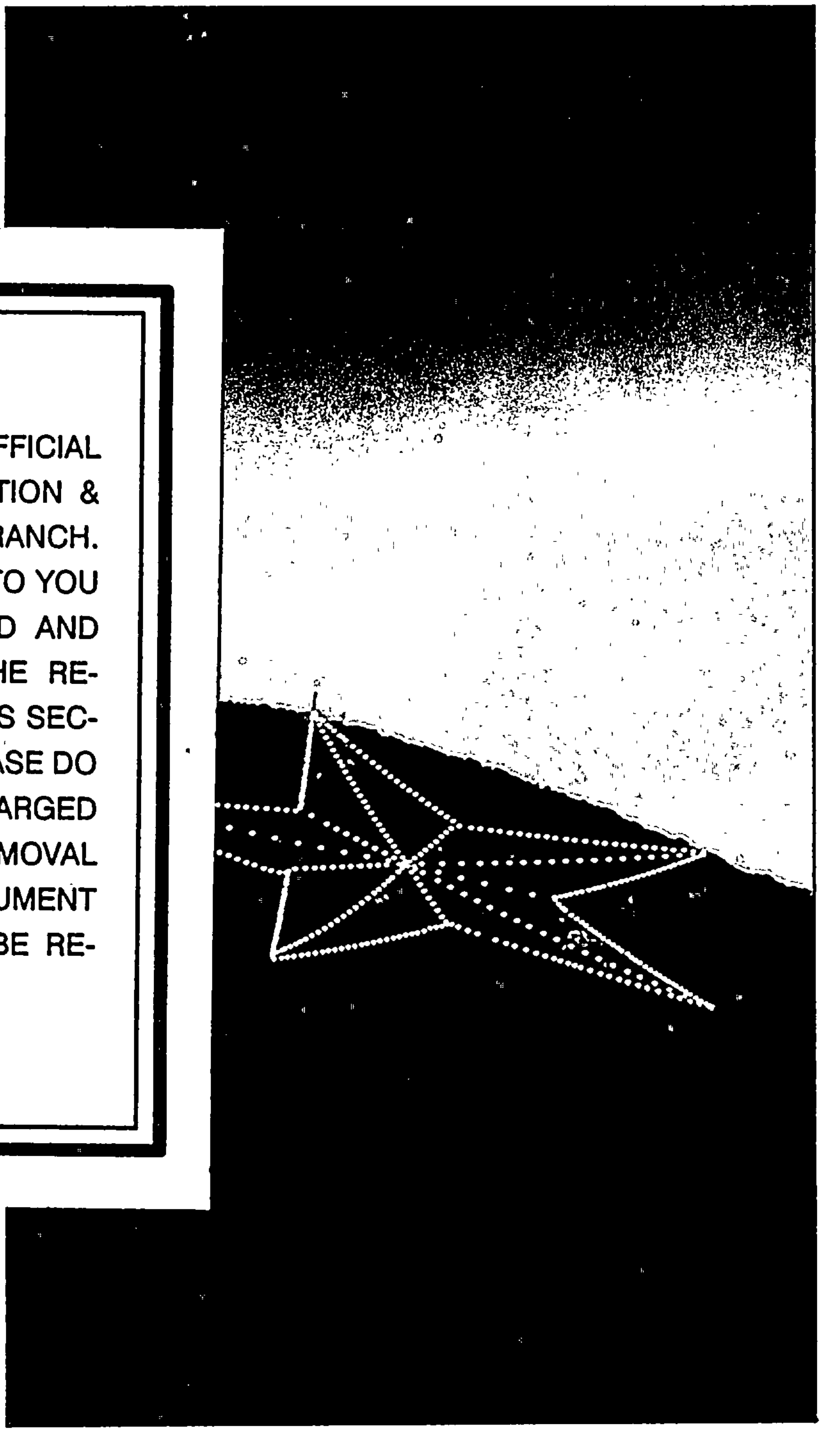
EL PASO ELECTRIC COMPANY



1990 ANNUAL REPORT

About the Cover:

El Paso Electric's "Star on the Mountain" remains lighted in support of Fort Bliss and other United States troops stationed overseas in Operation Desert Storm. The lighting of the star serves as a symbol of our community's support for all U.S. and Allied servicemen and women fighting for peace in the Middle East.

Cover Photography by Alan Lee Bunnell,
El Paso Electric Corporate Communications

ANNUAL MEETING OF SHAREHOLDERS

All shareholders are invited to attend the Annual Meeting of Shareholders on Monday, May 20, 1991, at 10 a.m., El Paso time in the Airport Hilton, 2027 Airways Blvd., adjacent to El Paso International Airport.

Proxies for the meeting are being solicited by the Board of Directors in a communication being mailed in conjunction with the mailing of this Annual Report. This Annual Report is not a part of such proxy solicitation and is not intended to be used as such.

TO OUR SHAREHOLDERS:

April 9, 1991

Our Company is at a crossroad. Over the past two years, we have come a long way. We have returned the Company to its core utility business, obtained financing, added senior management talent, revamped the Board of Directors, and restructured the Company's utility operations. And Palo Verde is back on line, producing record amounts of electrical power.

These are very significant accomplishments. Taken alone, however, they will not return the Company to profitability. But together they form the foundation necessary for the final critical ingredient — a rate structure which will allow the Company to cover its cost of service with a fair return to shareholders. We do not have that — yet.

David H. Wiggs, Jr. (seated), Chairman of the Board, President and Chief Executive Officer and Curtis L. Hoskins, Executive Vice President and Chief Operating Officer

FINANCIAL RESULTS

This is clearly demonstrated in the year-end results. For the twelve months ended Dec. 31, 1990, the Company recorded a net loss applicable to common stock of $33.7 million (after preferred dividend requirements of $11.9 million). The loss from continuing operations of $21.9 million (which includes net regulatory disallowances of $24.9 million) reflects in large measure the Company's inability to recover operating expenses under the existing Texas rate structure.

The Company's Texas revenue deficiency is over $131 million per year. Not surprisingly, the Company's earnings and equity base have been adversely affected. The Company is required to externally finance substantially all of its capital requirements, including regulatory deferrals, at a time when our financing capability is significantly limited. The common stock dividend has been omitted, and the value of the stock is still well below book value. The Company's long-term debt ratings also have been lowered.

A NEW DIRECTION

When I was elected Chairman of the Board and Chief Executive Officer in 1989, I knew it would be very difficult to restore the Company's profitability and credibility. I think we have made great strides with credibility. We must now achieve profitability.

The Company has significantly changed its corporate direction and decision-makers over the last two years. Since October 1989, seven new members have been elected to join me on the 11-member Board of Directors. The two most recent members joined the Board in the Fall of 1990. Richard G. Hickson, Chairman of the Board and Chief Executive Officer of Texas Commerce Bank El Paso, was elected effective October 1990, and Travis H. Petty, who recently retired as Vice Chairman of the Board of Burlington Resources, Inc., was elected effective November 1990.

At the same time, we have restructured senior management. Only four of 15 officers were part of the senior management team in 1988. And four are new to the Company. Joining me in that group are Curt Hoskins (Executive Vice President and Chief Operating Officer), John Droubay (Vice President and Treasurer), and Russell Gibson (Controller).

The commitment of the Board of Directors and senior management has been to return the Company to its basic utility business and to restore credibility, earnings stability and financial integrity. Toward that end, we have sold our non-utility investments, obtained new financing, omitted dividends on common stock, and reduced staff and overhead expenses. In addition, the Company is beginning to implement significant cost saving ideas generated by a Company-wide employee incentive program.

These actions have enabled banks involved in our Revolving Credit Facility (RCF) to continue to provide financial support under a difficult set of circumstances. Although the RCF expires on May 31, 1991, we have requested an extension of the facility through November 1991. This action would give the banks an opportunity to evaluate the results of the Company's rate case now pending before the Public Utility Commission of Texas.

Last year, I pointed out that there are two keys to the ultimate success of the Company — the efficient operation of Palo Verde and adequate rate relief. In 1990, we confronted those issues head on.

PALO VERDE

In response to Palo Verde's operating performance in 1989, the Operating Agent made sweeping changes, and our Company stepped up its oversight activities. The Board of Directors formed a Palo Verde Oversight Committee and has retained nationally recognized experts to advise and assist in this effort. The nuclear units are now producing record amounts of electric power, and we believe Palo Verde will prove to be an increasingly valuable asset.

Palo Verde produced more electricity last year than any other commercial nuclear plant in the country, and a Palo Verde unit was the top producer in 10 out of 12 months. In addition, Palo Verde cost less to build per unit of capacity than any other nuclear plant serving Texas. Finally, Palo Verde is a clean source of energy which is not negatively affected by the recently enacted amendments to the Clean Air Act. Nor is it affected by instability in the Middle East or the volatility of natural gas prices.

THE SINGLE MOST CRITICAL ISSUE FACING OUR COMPANY IS OBTAINING AN APPROPRIATE RATE STRUCTURE.

Indications are that as operating and maintenance expenses level off, and as Palo Verde's units continue to perform in line with industry standards, the Company and its customers will have an efficient and reliable source of power for years to come.

RATE RELIEF

That brings us face to face with the single most critical issue facing our Company — obtaining an appropriate rate structure.

Rate cases are exceedingly intricate and expensive. All manner of experts (rate consultants, financial advisors, accountants and attorneys) grapple with each other and with mountains of documents and an avalanche of numbers — all against a background of complicated ratemaking concepts. While these matters are extremely important, I believe the single most critical element in a rate case is credibility. While some may disagree, I believe we have that now.

The Company is presenting a rate case which is free from collateral issues. Our corporate house is in order, and our rate request is sound.

Years of confrontation with the City of El Paso over rates has been an expensive, time consuming, and contentious process — perhaps unavoidable, but not preferred. This time around, the Company was determined to try a fresh approach designed to reduce tensions and increase cooperation. We worked for several months with City rate consultants in an effort to reach an agreement which the Company believed would resolve issues over the next ten years.

At the same time, however, the Company filed a rate case with the Texas Commission for (i) its fourth increase under the terms of the Rate Moderation Plan approved by the Commission in 1988, and (ii) the recovery through a rate moderation plan of the Texas portion of the Company's investment in Palo Verde Unit 3. The details of this most recent case (and other pending rate matters) are discussed at length in the attached Form 10-K.

Suffice it to say, however, that the Company is seeking a total increase in base revenues of approximately $131 million ($82 million of which relates to Palo Verde Unit 3 and $49 million of which relates to Palo Verde Units 1 and 2).

BOARD OF DIRECTORS

David H. Wiggs, Jr. (3)
Chairman of the Board, President and Chief Executive Officer

Wilfred E. Binns (8)
President and Sole Shareholder, Binns Construction & Realty, Inc., Las Cruces, New Mexico

William L. Boyan *
Chief Financial Officer, John Hancock Mutual Life Insurance Co., Boston, Mass.

James A. Cardwell (1)
President and Principal Shareholder, Crinco Investments, Inc., El Paso, Texas (multi-business holding and investment company)

Richard G. Hickson *
Chairman and President, Texas Commerce Bank - El Paso, N.A., El Paso, Texas

Hector Holguin (1)
Chairman and Chief Executive Officer, Accugraph Corp., El Paso, Texas (computer-aided design software)

Travis H. Petty *
Retired Vice Chairman of the Board, Burlington Resources, Inc. (energy and natural resources), Seattle, Wash.

Josefina A. Salas-Porras (12)
Educator, El Paso, Texas (consultant in second language and multi-cultural training)

John C. Schweitzer (1)
Managing Partner, Continental Properties Company, Austin, Texas (real estate and investments)

Tom C. Simpson (8)
President and Principal Shareholder, Simpson Farms, Inc., Las Cruces, New Mexico

William D. Skov (1)
Partner, Skov Farms, SK-Farms, Paso Pork Producers, Clint, Texas; Chairman, First National Bank of Fabens, Texas

COMPANY OFFICERS

David H. Wiggs, Jr. (3)
Chairman of the Board, President and Chief Executive Officer

Curtis L. Hoskins (1)
Executive Vice President and Chief Operating Officer

William J. Johnson (13)
Senior Vice President-Financial Group and Chief Financial Officer

William W. Royer (10)
Senior Vice President-Special Projects

Ignacio R. Troncoso (21)
Senior Vice President-Operations Group

Lawrence M. Downum, Jr. (31)
Vice President-Corporate Services Division

Frederic E. Mattson (21)
Vice President-Power Supply Division

Eduardo A. Rodriguez (9)
Secretary and General Counsel

Julius F. Bates, Jr. (19)
Vice President-Customer Services, Texas Division

John E. Droubay (1)
Vice President and Treasurer

Russell G. Gibson (1)
Controller

Gary R. Hedrick (13)
Vice President-Financial Planning and Rate Administration

John C. Horne (18)
Vice President-Transmission System Division

James A. Mayhew (11)
Vice President-Rates and Energy Utilization

Robert C. McNiel (13)
Vice President-Customer Services, New Mexico Division

( ) Years of Service

* Mr. Hickson was elected to the Board of Directors effective October 1990, and Travis H. Petty was elected to the Board effective November 1990. Mr. Boyan was elected to the Board of Directors effective May 1990.

A complete copy of the Company's 1990 Form 10-K report, filed with the Securities and Exchange Commission, including Financial Statements and Financial Statement schedules, will be provided to shareholders without charge upon written request to: Eduardo A. Rodriguez, Secretary, El Paso Electric Company, Post Office Box 982, El Paso, Texas 79960.

Although the City Council voted not to accept the Company's settlement proposal, we are encouraged by the cooperative effort which was displayed by both sides. Toward that end, the City expedited local proceedings, and the case is now before the Texas Commission. Hearings are scheduled for later this month, with a decision expected in the fourth quarter.

Our goal is to achieve a rate path which will provide sufficient operating revenues, earnings and cash flow to enable the Company to finance and to eventually reduce debt and pay dividends to common shareholders. We believe this can be done with rates which are affordable to our customers and which do not inhibit economic growth in the Company's service area.

SERVICE AREA
In that regard, our service area continues to grow. The number of customers served, native system sales, total system sales, native system peak, and total system peak all recorded increases over 1989, albeit at rates below the extremely high growth rates of the prior year. Against that background, the Company is currently projecting that the annual growth rates between now and the year 2000, for native and total system peak loads, will be 2.5 percent and 2.2 percent, respectively.

In addition, on April 8, 1991, the Company signed a 5-1/2 year contract with the Republic of Mexico to provide firm power sales to Mexico's rapidly growing northern border area. The contract calls for an initial capacity of 40 megawatts (MW), increases to 120-150 MW no sooner than Jan. 1, 1992, and continues at that level through 1996. Mexico has experienced exceptional growth in the demand for electricity, and the Company is strategically located to supply a portion of that demand. This is a significant contract that the Company has been working on for more than a year. We are very pleased to have completed this agreement and remain optimistic about the potential for additional sales. Finally, we expect to renew our franchise with the City of Las Cruces, New Mexico, which expires March 1993. Although the City is considering other energy alternatives, we are currently involved in constructive discussions with the City which we believe will lead to a new franchise.

STRATEGIC PLANNING
Though we are deeply involved with the present, we are not neglecting the future. The Company's 10-year strategic action plan sets specific corporate goals — among them, to return the Company to profitability; to capitalize on the growing energy market in Mexico; to maximize the benefits of, and a return on, our investment in Palo Verde; to become the customers' preferred energy choice; and to achieve a respected corporate presence.

In last year's letter, I urged you to take a few minutes to review the accompanying Form 10-K. I do so once again.

Over the past two years, we have confronted a myriad of challenges. With the support of shareholders and the financial community, we have overcome most. One remains.

Proper rate relief — and management's resolve — will allow the Company to continue down the long road to recovery.

Thank you for your support.

Sincerely,

David H. Wiggs, Jr.

David H. Wiggs, Jr.
Chairman of the Board, President and Chief Executive Officer

SECURITIES AND RECORDS

The common stock of El Paso Electric Company is traded in the over-the-counter market and quoted on the NASDAQ National Market System. The ticker symbol for the common stock is ELPA.

El Paso Electric and The Bank of New York (BONY) act as co-transfer agents and co-registrars for the Company's common and preferred stock. BONY maintains all shareholder records of the Company.

SHAREHOLDER INFORMATION

Shareholders may obtain information relating to their share position, dividends, transfer requirements, lost certificates, and other related matters by telephoning:
BONY Shareholder Services at
1-800-524-4458.

This service is available to all shareholders Monday through Friday,
8 a.m. to 6 p.m., Eastern Time.
Shareholders also may obtain this information by writing to:
Shareholder Services, BONY
90 Washington Street
New York, New York 10286.

SHAREHOLDER INQUIRIES

Shareholders should direct questions about the activities and operating results of the Company to:
The Office of the Secretary
El Paso Electric Company
P.O. Box 982
El Paso, Texas 79960.

For toll-free telephone calls within Texas, the number is 1-800-592-1634. For toll-free telephone calls elsewhere in the United States, dial 1-800-351-1621.

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El Paso Electric Company
Board of Directors

David H. Wiggs, Jr. [2]

Wilfred E. Binns [2]

William L. Boyan [3]

James A. Cardwell [1]

Richard G. Hickson [2]

Hector Holguin [1]

Travis H. Petty [2]

Josefina A. Salas-Porras [1]

John C. Schweitzer [2]

Tom C. Simpson [3]

William D. Skov [3]

[1] *Audit/Ethics Committee*
[2] *Executive/Nominating Committee*
[3] *Compensation/Benefits Committee*

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

(Mark One)

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (FEE REQUIRED)
For the fiscal year ended December 31, 1990

OR

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (NO FEE REQUIRED)

For the transition period from __________ to__________

Commission file number 0-296

El Paso Electric Company

(Exact name of registrant as specified in its charter)

Texas (State or other jurisdiction of incorporation or organization)	74-0607870 (I.R.S. Employer Identification No.)
303 North Oregon Street, El Paso, Texas (Address of principal executive offices)	79901 (Zip Code)

Registrant's telephone number, including area code: 915-543-5711

None of the Registrant's Securities is Registered Pursuant to Section 12(b) of the Act

Securities Registered Pursuant to Section 12(g) of the Act:

COMMON STOCK, NO PAR VALUE
(Title of Class)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES _X_ NO ___.

As of February 28, 1991, the aggregate market value of the voting stock held by non-affiliates of the registrant was $254,275,408.

As of February 28, 1991, there were outstanding 35,502,541 shares of common stock, no par value.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement for the 1991 annual meeting of its shareholders are incorporated by reference into Part III of this report.

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PART I

PART II

PART III

PART IV

DEFINITIONS

The following abbreviations or acronyms used in this report are defined below:

Abbreviations or Acronyms	Terms
ADR	Arizona Department of Revenue
AFUDC	Allowance for Funds Used During Construction
AIP	Arizona Interconnection Project
APS	Arizona Public Service Company
CCN	Certificate of Convenience and Necessity
CFE	Comision Federal de Electricidad — Mexico
Common Plant or Common Facilities	Facilities at or related to the Palo Verde Station that are common to all three Palo Verde Units
Company	El Paso Electric Company
CWIP	Construction Work in Progress
DOE	United States Department of Energy
EPA	United States Environmental Protection Agency
FERC	Federal Energy Regulatory Commission
Four Corners	Four Corners Project or Four Corners Plant
Franklin or Franklin Land	Franklin Land & Resources, Inc., a former subsidiary of the Company
IID	Imperial Irrigation District, an irrigation district in Southern California
IRS	Internal Revenue Service
KV	Kilovolt
KW	Kilowatt(s)
KWH	Kilowatt-hour(s)
MW	Megawatt(s)
MWH	Megawatt-hour(s)
NASDAQ	National Association of Securities Dealers Automated Quotations System
New Mexico Commission or NMPSC	New Mexico Public Service Commission
NMEID	New Mexico Environmental Improvement District
NRC	Nuclear Regulatory Commission
PCBs	Polychlorinated Biphenyls
Palo Verde Station or Palo Verde Project or Palo Verde or PVNGS	Palo Verde Nuclear Generating Station
PasoTex	PasoTex Corporation, a former subsidiary of the Company
PNM	Public Service Company of New Mexico
RCF	Credit Agreement dated as of October 26, 1989, as amended, among El Paso Electric Company, each of the Banks signatory thereto, and Chemical Bank, as Agent Bank
SFAS	Statement of Financial Accounting Standards
SNMTS	Southern New Mexico Transmission System
Texas Commission	Public Utility Commission of Texas
TNP	Texas-New Mexico Power Company
TPHs	Total Petroleum Hydrocarbons
Tribe	Navajo Indian Tribe
TWC	Texas Water Commission

Regulation

Texas. The rates and services of the Company in Texas municipalities are regulated by those municipalities and in unincorporated areas by the Texas Commission. The Texas Commission has exclusive de novo appellate jurisdiction to review municipal orders and ordinances regarding rates and services, and its decisions are subject to judicial review.

New Mexico. The New Mexico Commission has authority over the Company's rates and services in New Mexico, the issuance of securities by the Company and other matters affecting the operations of the Company.

FERC. The Company is subject to regulation by the FERC in certain matters, including rates for wholesale power sales and the issuance of securities. In addition, Congress has enacted energy legislation which, among other things, establishes national standards for consideration by state regulatory agencies in determining utility rates and imposes other requirements on the operations of utilities, including the Company. Under certain circumstances, the FERC may order interconnection, wheeling and pooling.

NRC. The Palo Verde Station is subject to the jurisdiction of the NRC, which has authority to issue permits and licenses and to regulate nuclear facilities in order to protect the health and safety of the public from radiation hazards and to conduct environmental reviews pursuant to the National Environmental Policy Act. Before any nuclear power plant can become operational, an operating license from the NRC is required. The NRC has granted facility operating licenses for Unit 1, Unit 2 and Unit 3 for terms of forty years each beginning December 31, 1984, December 9, 1985 and March 25, 1987, respectively. See "Facilities — Palo Verde Station."

Texas Rate Matters

Rate Moderation Plan — Palo Verde Units 1 and 2. On March 30, 1988, in Docket 7460, the Texas Commission adopted a rate moderation plan which provides for the inclusion in Texas rates, on a phase-in basis, of the Texas jurisdictional portion of the Company's investment in Palo Verde Unit 1, Common Plant and the Company's lease payments on its sales and leasebacks of its interest in Palo Verde Unit 2 (including one-third of such Common Plant) to the extent of the book value of the plant sold and leased back (which is approximately 83% of such lease payments).

The Texas Commission's order was based upon a stipulation entered in October 1987 between the Company, the staff of the Texas Commission and certain industrial customers. Three parties who did not join in the stipulation, the City of El Paso and two other intervenors representing public entities, opposed the adoption of the stipulation as the basis of the Commission order and appealed the order to state district court in Travis County, Texas. The district court upheld the order of the Texas Commission, and its decision was appealed by the same parties to the Court of Appeals for the 3rd Judicial District at Austin, Texas. After briefing and oral arguments by the parties on the merits, the appellate court requested briefs from the parties concerning whether the Texas Commission's order is a final order under its terms. The Court raised the issue on its own motion, and all parties to the appeal submitted briefs supporting the finality of the order. If the appellate court were to find that the order was not a final order, the case would be remanded to the Texas Commission, which could reconsider the case in its entirety. If the case were to be remanded to the Texas Commission, the most likely outcome, in the Company's opinion, is that the Texas Commission would take such action as would be necessary under the Court's ruling to make the order final without impacting the matters ordered by the Texas Commission in the present order. A ruling on the appeal is expected in the spring of 1991. Although the outcome of the appeal cannot presently be determined, the Company believes that the appellate court will rule that the Texas Commission's order is a final order and that the Texas Commission's order will be upheld on appeal.

The stipulation and the Texas Commission's final order settled all issues regarding prudence of construction of Palo Verde Units 1 and 2 and Common Facilities and all issues involving the prudence

PART I

Item 1. Business

General

The Company was incorporated in Texas in 1901. Its principal business is the generation and distribution of electricity through an interconnected system to approximately 244,000 customers in El Paso, Texas and in an area in the Rio Grande Valley in West Texas and Southern New Mexico. The Company's principal executive offices are located at 303 North Oregon Street, El Paso, Texas 79901 (telephone 915-543-5711).

The Company's service area extends approximately 110 miles northwesterly from El Paso to the Caballo Dam in New Mexico and approximately 120 miles southeasterly from El Paso to Van Horn, Texas. The service area has an estimated population of 743,000, including approximately 605,000 people in the metropolitan area of El Paso. Copper smelting and refining, oil refining, garment manufacturing, cattle raising and agriculture are important industries in El Paso, which is also an important transportation and distribution center. At December 31, 1990, the Company's largest retail customers included a steel fabricator, a copper refinery, an oil refinery, and a smelter in El Paso, and important military installations, namely the U.S. Army Air Defense Center at Ft. Bliss in El Paso and the White Sands Missile Range and Holloman Air Force Base in New Mexico.

The Company's major franchises are with the cities of El Paso, Texas and Las Cruces, New Mexico. Such franchises expire in 2001 and 1993, respectively, and do not contain renewal provisions. The Company believes, but has no assurance, that both franchises will be renewed, although the City of Las Cruces is currently reviewing possible alternatives to renewal of the franchise. See Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations — Results of Operations."

During 1990, approximately 64% of the Company's operating revenues were derived from Texas, 19% from New Mexico and 17% from FERC wholesale customers. Sales to (i) residential customers, (ii) small commercial and industrial customers, (iii) large commercial and industrial customers and (iv) public authorities accounted for approximately 35%, 34%, 13% and 18%, respectively, of the Company's operating revenues from retail sales. In 1990, IID, a wholesale customer, accounted for 10.3% of operating revenues. No retail customer accounted for more than 3% of operating revenues. The effect of seasonal sales by quarter are insignificant to the Company's annual operating revenues, but the third quarter of each calendar year traditionally contributes approximately 28% of annual revenues due to the climate in the Company's service area. See Note O of Notes to Financial Statements.

The Company attained an all-time system peak load of 1,098 MW on June 27, 1990 which represents a 2.04% growth over last year. This compares to 7.39% increase from the previous year. Native system peak load increased .44% in 1990 to 920 MW as compared to a 9.05% increase the prior year. The Company periodically makes long-range projections of system peak load and estimates future sources of power that may be used to supply the system requirements. The projected annual native and total system peak load growth rate for the Company's service area during the 1991-2000 time period is approximately 2.5% and approximately 2.2%, respectively.

The Company had 1,053 employees as of December 31, 1990. Approximately 29% of the employees are covered by a collective bargaining agreement that expires in February 1993.

of the Company's decisions to make the investment in the Palo Verde Project and to continue that investment, except, as to Unit 3 only, decision making relating to events occurring after the 1978 issuance by the Texas Commission of a CCN for the Palo Verde Project. See discussion below regarding the Unit 3 rate case. The stipulation also settled all issues of excess capacity relating to Units 1 and 2 for the duration of the ten-year rate moderation plan, and the Texas Commission has indicated that it will not consider excess capacity issues relating to Units 1 and 2 during such time period.

The Texas Commission's order in Docket 7460 limits the Company to specified base rate (cash) increases during the first four years of the plan. The plan requires that the Company file rate cases annually to establish the Company's revenue requirements and resulting right to the base rate increases. To the extent the Company's base revenue requirements recognized by the Texas Commission exceed the base rate increase provided for the period, the unrecovered revenue requirements are deferred for collection in later years of the plan. The plan, which is explicitly intended to comply with SFAS No. 92, *Regulated Enterprises — Accounting for Phase-In Plans*, requires all revenue deferrals to be recovered within the ten-year term of the plan. The Company is, under the plan, entitled to additional base rate increases for years subsequent to the scheduled fourth increase, if necessary, to recover all such deferrals during such time period. The Company has, in its current filing in Docket 9945 (described below) indicated the need for additional base rate increases under the Docket 7460 plan of at least 3.5% in each of the six remaining years of the plan. See "Palo Verde Unit 3" below.

The Texas Commission has entered final orders providing for the first three scheduled base rate increases under the Docket 7460 plan. The first increase of approximately $21 million, together with deferral of approximately $25 million, was ordered in Docket 7460. In May 1989, the Texas Commission entered its final order in Docket 8363, which granted the scheduled second increase in base rates of approximately $7.3 million and ordered deferral of approximately $7.4 million. The Company had requested in Docket 8363 an increase in base revenues of approximately $39 million. The Texas Commission's order in Docket 8363 was appealed by the Company and other parties to the case to state district court in Travis County, Texas, where the appeal remains pending. A decision on the appeal is not expected before the end of this year. The outcome of the appeal cannot presently be determined.

In August 1990, the Texas Commission entered its final order in Docket 9165, which granted the scheduled third base rate increase of approximately $7.1 million and ordered deferral of approximately $4.1 million. The Company had requested an increase in base revenues of approximately $33.9 million. Rates based upon the final order in Docket 9165 became effective in September 1990. In connection with the final order, the Company wrote off approximately $4 million of corporate restructuring costs, rate case expenses, and deferred tax benefits. The Company and the City of El Paso have appealed the Texas Commission's order in Docket 9165 to state district court in Travis County, Texas, where the appeal remains pending. No decision on the appeal is expected before the end of this year, and the outcome of the appeal cannot presently be determined.

On December 28, 1990, the Company filed for the scheduled fourth increase in base rates under the terms of the Docket 7460 plan and for the recovery of the Texas portion of the Company's investment in, and lease payments on, Palo Verde Unit 3. For a description of the filing, see "Palo Verde Unit 3" below.

Palo Verde Unit 3. Palo Verde Unit 3 began commercial operation in January 1988. The unit did not, however, satisfy Texas Commission criteria for in-service status, and consequent eligibility for inclusion in Texas rates, until the AIP transmission facilities were energized in April 1990. Construction of the AIP transmission facilities was completed in December 1989 and the line was energized as part of an arbitration agreement entered into by the Company and PNM, under which the parties agreed to submit to binding arbitration the entitlement of the parties to transmission rights and capabilities involving the SNMTS, to which the AIP transmission facilities are interconnected. The Texas Commission has ruled that Unit 3 met the Texas criteria for in-service status for ratemaking purposes as of May 4, 1990. For a description of the AIP, see "Facilities — Transmission Lines."

In September 1989, the Company filed an application with the Texas Commission for an accounting order to allow the Company to defer substantially all Unit 3 operating costs (excluding fuel) and to accrue a carrying charge on its ownership interest in Unit 3, from the date Unit 3 satisfied the Texas in-service criteria until the Texas Commission issues its rate order addressing the Company's investment in Unit 3. Operating and maintenance expenses associated with the AIP transmission line were not included in the Company's request for the deferral order. On August 29, 1990, the Texas Commission approved the Company's application for the accounting order. From May 4, 1990, through the end of 1990, the Company deferred approximately $31.9 million of Unit 3 costs pursuant to this accounting order. The Company has requested in its Docket 9945 filing that all Unit 3 costs deferred through the effective date of the rate order addressing the Company's investment in Unit 3 be recovered over the remaining life of the asset. The Company believes, based upon past practice of the Texas Commission with regard to inclusion in rates of amounts deferred pursuant to approved accounting deferral orders, that such amounts will be recovered.

On December 28, 1990, the Company filed with the Texas Commission (Docket 9945) a combined request for the scheduled fourth base rate increase under the Docket 7460 rate moderation plan on Units 1 and 2, including the Company's investment in AIP, and the recovery of the Texas jurisdictional portion of the Company's investment in Palo Verde Unit 3 and the lease payments, net of deferred gain, on the Company's sales and leasebacks of a 40% interest in Unit 3. The filing requests a rate moderation plan incorporating three increases, with respect to the Company's interest in Unit 3, designed to comply with SFAS No. 92, *Regulated Enterprises — Accounting for Phase-In Plans.* The Unit 3 plan would continue through 1999. The Company, under its filing, would be entitled to additional base rate increases for years subsequent to the scheduled third increase, if necessary, to recover all deferrals during the term of the Unit 3 plan.

The Company's filing in Docket 9945 seeks a total increase in base revenues of approximately $131.3 million (approximately $82.3 million for Unit 3 and approximately $49 million for Units 1 and 2), consisting of an approximate $38 million cash increase, which includes approximately $7.6 million for the scheduled fourth base rate increase under the Docket 7460 plan for Units 1 and 2, and approximately $30.4 million for the scheduled first base rate increase on Unit 3, and approximately $93.3 million in revenues to be deferred, with a return thereon, for collection in later years. The requested base rate increase, net of approximately $3.8 million of fuel savings, is approximately $34.2 million (a 12.1% increase in total Texas revenues).

Issues relating to the prudence of construction costs directly attributable to Unit 3 and issues relating to the prudence of the Company's decisions to continue the level of its Unit 3 investment, insofar as those issues relate to events occurring after 1978 were not resolved by the Docket 7460 decision involving Units 1 and 2 and are therefore open for decision in the Unit 3 case. However, the Company believes the construction costs of Palo Verde were prudent and reasonable and that its decisions to continue the level of its investment in Unit 3 after the 1978 issuance by the Texas Commission of the CCN were prudent. The Company, therefore, does not expect any material disallowance of Unit 3 costs on the basis of construction imprudence or decisional imprudence. The Company believes that, among other reasons, the outcome of the prudence audit ordered by the Arizona Corporation Commission demonstrates that the construction costs of Palo Verde were prudent and reasonable. The report on the prudence audit, released by Ernst & Whinney on March 24, 1989, identified approximately $60 million of costs, excluding AFUDC and property taxes, for the entire Palo Verde project that were unreasonable; neither the Company nor APS accepts such finding. Of the $60 million, the Company's share would be approximately $9.5 million. The report also identified certain areas that were found to exceed the standard of reasonableness and to have a positive impact on the Palo Verde Project, including built-in separation of electrical equipment, design replication of the three Palo Verde Units, certain aspects of the regulatory (licensing) management function, and certain labor and contractual arrangements. The report estimated that the potential direct cost savings of the identified areas in which performance exceeded the standard of reasonableness were approximately $300 million for the entire project (excluding AFUDC and property taxes), of which the Company's share would be approximately $47.4 million.

The Company expects that parties to Docket 9945 adverse to the Company will assert that Unit 3 represents "excess capacity." The Company continues to believe that Unit 3 is not "excess capacity" and will strenuously defend that position and will continue to seek the full recovery of Unit 3 costs and the inclusion of the unit in rate base. If any excess generating capacity were to be found by the Texas Commission relating to Unit 3, the Company believes the amount of any resulting exclusion from rate base would probably be temporary and would be restored to rate base in future rate proceedings to permit full recovery of substantially all of the Texas jurisdictional portion of the Company's investment in Unit 3. If the Company were denied adequate and timely rate relief sufficient to recover the investment and a fair return thereon, the Company would resort to the courts for the rate relief to which it believes it is entitled. Although the Company does not believe it is probable that significant additional write-offs from regulatory disallowances will occur as a result of the outcome of Docket 9945, the ultimate outcome of the case cannot presently be determined.

Failure to receive sufficient inclusion in Texas rates of the Company's Unit 3 investment, on a timely basis, would increase the Company's external financing requirements and could adversely affect access to the capital markets. An adverse regulatory decision by the Texas Commission with respect to the Company's investment in Unit 3 which, in the judgment of the lending banks under the RCF, causes the Company's revenues to be insufficient to assure its ongoing viability or its access to capital markets or its ability to repay its obligations, constitutes an event of default under the RCF. See "Management's Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources."

Hearings on Docket 9945 before the Texas Commission are scheduled to begin in late April 1991, and a final order from the Texas Commission is expected during the fourth quarter of 1991. The Company may seek to place a portion of its requested cash rate relief into effect under bond, subject to refund, as of mid summer; bonding would, absent a refund, reduce the amount of deferred costs recorded. See Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

On March 12, 1991, the Company made a proposal to the City of El Paso for the settlement of its Texas jurisdictional revenue requirement over the next ten years. The Company's proposal included a ten-year plan for the inclusion of Unit 3 in Texas rates along with previously allowed costs under the Docket 7460 rate moderation plan for Units 1 and 2. On March 18, 1991, the City Council of the City of El Paso, in a meeting to review the settlement proposal, voted to reject the proposal. As a result, the Company's case in Docket 9945 before the Texas Commission will proceed as discussed above, and the settlement proposal will, in accordance with the agreement of the parties, have no precedential or evidentiary value in the case.

Fuel Reconciliation Case — Docket 8588. In June 1989, the Company filed an application with the Texas Commission to reconcile its fuel expenses and revenues for the period August 1, 1985 through March 31, 1989, which included over $200 million in Texas fuel costs. Reconciliation was required by Texas Commission rules and the Commission's final order in Docket 7460. On August 15, 1990, the Texas Commission rendered its final order, which was modified in response to motions for rehearing and resulted in a refund to Texas customers, to be made over a twelve-month period, of approximately $7.1 million, plus interest at the Company's composite cost of capital. As a part of its order, the Texas Commission disallowed approximately $1.3 million of costs included in the Company's nuclear fuel expense during the reconciliation period, which costs were incurred by the Company in connection with a joint venture formed to secure supplies of uranium fuel for the Company's interest in Palo Verde. In the third quarter of 1990, the Company recorded a regulatory disallowance of approximately $14.0 million, which represents fuel cost adjustments through March 1989, related adjustments through July 1990, interest on the refund, and approximately $4.2 million of unamortized costs related to the nuclear fuel joint venture, which, while not included in the fuel reconciliation case, were considered unrecoverable in future filings in light of the Commission's ruling in the fuel reconciliation case. The refund to customers began in February 1991. The Company and the City of El Paso have appealed the Texas Commission's order to state district court in Travis County, Texas. The Company expects a decision on the appeal by the end of 1991. The Company cannot predict the outcome of the appeal at this time.

Rate Case Expenses Incurred in Docket 7460. Expenses incurred by the Company and the City of El Paso in connection with Docket 7460 were severed from the issues ruled upon by the Texas Commission in that Docket and were assigned to a new Docket (8018) for consideration. The Company had applied for the immediate recovery of approximately $5 million of such expenses through a surcharge to customers and proposed that the balance of the expenses, attributable to the prudence phase of Docket 7460, be amortized and recovered in rates over the remaining life of the Palo Verde units. The hearing examiner's report recommended that the Company be reimbursed for approximately $10.6 million and that the City of El Paso be reimbursed for approximately $1.1 million of such rate case expenses, and that such amounts be surcharged to the Company's Texas customers over a one-year period. On August 15, 1990, the Texas Commission ordered additional hearings in Docket 8018 for the limited purpose of confirming certain evidentiary matters pertaining to approximately $7.4 million of such rate case expenses. Such hearings were held March 18, 1991. The Company expects a final ruling from the Texas Commission on the case in the summer of 1991. The expenses are included as a deferred charge in the Company's balance sheet. If such expenses were disallowed, which the Company does not expect, the expenses to the extent of the disallowance, would be charged to operations as a regulatory disallowance.

Texas Recognition of Palo Verde Sales and Leasebacks. In its Docket 8363 order and a separate order issued in August 1989, the Texas Commission found the Company's Unit 2 and Unit 3 sales and leasebacks to be in the public interest. The ruling, in the case of the Unit 3 sales and leasebacks, insures that the Commission will consider those transactions in connection with the Company's Unit 3 rate case. The City of El Paso appealed the Commission's order with respect to the Unit 3 transactions to state district court in Travis County, Texas. The appeal is not expected to be ruled upon this year. The Company believes that the court will uphold the Commission's order. The finding on the Unit 2 sales and leasebacks is a part of the City's appeal of the Docket 8363 order.

Performance Standards for Palo Verde — Texas. In June 1989, the Company filed an application with the Texas Commission to establish performance standards in its Texas jurisdiction for the operation of the Palo Verde units. On March 27, 1991, the Texas Commission issued its final order in the case, which resulted in standards based on a three-year rolling average of performance, applied on a unit specific basis. As a consequence, each Palo Verde unit will be evaluated annually, based upon a three-year rolling average capacity factor (the ratio of actual generation to maximum possible generation), against performance bands measured from a target capacity factor of 70%. The "deadband," where neither a penalty nor a reward would be triggered, runs from 62.5% to 77.5%. Penalties or rewards will result from worse or better performance, respectively, and will be calculated as a function of incremental replacement power costs. If a unit performs at an annual capacity factor of less than 35%, the staff of the Texas Commission is, under the performance standards, required to file a proceeding for the purpose of determining whether the unit should continue to be included in Texas rates. The Company does not believe that this requirement applies to the Unit 1 unscheduled outages in 1989 and 1990. If the requirement was interpreted to apply to such outages, the Company believes that the Texas Commission would find that Unit 1 should continue to be included in Texas rates. The standards are effective with the initial date of ratebase inclusion of the respective units. Therefore, such standards will cover, retroactively, the extended 1989 outages at Palo Verde. The Company calculates an initial penalty of approximately $2.8 million for Units 1 and 2. An additional penalty for Units 1 and 2 is projected for the second year of the standard's operation, based upon the use of the three-year rolling average. The Company estimates the entire penalties which will be sustained as a result of the 1989 Palo Verde outages is approximately $5 million; provision for loss for such penalties has been made in the Company's 1990 financial statements. The penalties will be credited to Texas customers through the next Texas fuel reconciliation filing. At least one of the intervenors in the case has indicated it will pursue an appeal.

Texas Recovery of Fuel Expenses. In its Texas jurisdiction, the Company recovers its fuel expenses and purchased power costs pursuant to a fuel factor set by the Texas Commission in each general rate request filed by the Company. The Texas Commission has the authority to order proceedings periodically for the purpose of reconciling the Company's fuel revenues against actual fuel expenses. As part of the Company's pending rate case in Docket 9945 (see discussion above in "Palo Verde Unit 3"), the Company applied for reconciliation of its fuel costs, after giving effect to adjustments in Docket 8588, covering the period April 1989 through September 1990, and the establishment of a new fixed fuel factor. The Company requested that the Commission determine that the Company underrecovered its fuel costs during such reconciliation period by $11.4 million. Based on the decision in the Texas performance standards case discussed above, the Company has filed a request to withdraw its request for a fuel reconciliation from Docket 9945 and to refile a new fuel reconciliation case, incorporating the performance standard penalties.

New Mexico Rate Matters

In March 1987, the New Mexico Commission adopted a rate moderation plan which provides for the regulatory treatment of the New Mexico jurisdictional portion of the Company's investment in all three units at Palo Verde, with Unit 3 being deregulated. Similar to the Texas plan for Units 1 and 2 (Docket 7460 described above), the New Mexico plan provides that, to the extent the Company's base revenue requirements determined by the New Mexico Commission exceed the base rate increase provided for the period, the unrecovered revenue requirements are deferred for collection in later years of the plan. SFAS No. 92, which governs accounting for rate phase-in plans, was not in existence at the time of the adoption of the New Mexico plan. As a result of the New Mexico plan provision that deferrals not recovered prior to December 31, 1994 will not be recovered in New Mexico rates, the New Mexico plan does not comply with SFAS No. 92. The Company filed an application with the New Mexico Commission, requesting that the plan be amended to bring it into compliance with SFAS No. 92. On August 3, 1990, the New Mexico Commission denied the Company's request. As a result, the Company recorded at June 30, 1990 a write-off, net of tax, of approximately $5.1 million of recorded phase-in deferrals and has discontinued reporting for financial statement purposes the unrecovered revenue requirements deferred for collection under the plan. However, to the extent the Company's base rates in New Mexico exceed its New Mexico base revenue requirements during the term of the New Mexico plan, the Company is entitled to collect such differences in cash rates, for application to unrecovered revenue requirements pertaining to earlier years of the plan. A stipulated settlement of the scheduled third base rate increase under the plan was approved by the New Mexico Commission effective May 1, 1990. The Commission's order provided for an increase in base rates of approximately $1.8 million and deferral of approximately $0.7 million. The Company had requested an increase in base revenues of approximately $8.5 million.

The Company will be required to recover the New Mexico jurisdictional portion of the Company's investment in Unit 3, which is deregulated under the New Mexico rate moderation plan, through off-system sales in the economy energy market. Market prices for economy energy sales have not been in recent years, and are not presently, at levels sufficient to recover the New Mexico portion of the Company's current operating expenses related to Unit 3, including lease payments. However, the Company believes that over the useful life of Unit 3, based upon its current forecast of plant operating costs and performance, power needs of other utilities and alternative fuel prices, the Company will be able to recover the New Mexico portion of its Unit 3 costs through such sales of power. See "Management's Discussion and Analysis of Financial Condition and Results of Operations."

The Company is subject to performance standards in its New Mexico jurisdiction for the operation of the Palo Verde units. The standards measure performance of the three units annually, viewed as a single generating station, against designated levels of capacity factors. If the annual capacity factor of the station exceeds 75% capacity, the Company is entitled to a monetary reward based upon the additional fuel costs avoided, calculated with reference to the Company's weighted average fuel and purchased power costs (other than Four Corners, Palo Verde and purchases from Southwestern Public Service Company). If the annual capacity factor falls below 60% capacity, the Company is penalized based upon the additional fuel costs incurred using the same formula. If annual performance falls between 60% and 75%, no consequences result. In 1990, the Palo Verde units performed within this deadband and the Company did not experience any penalties or rewards.

In its New Mexico jurisdiction, the Company recovers its fuel expenses and purchased power costs through a fuel factor set by the New Mexico Commission. The New Mexico rate moderation plan requires that the fuel factor be fixed each year during the term of the plan. On January 31, 1990, the Company filed a request for a new fuel factor in its New Mexico jurisdiction. The requested fuel factor reflected an estimated penalty of $3 million recorded by the Company in 1989 under the New Mexico performance standards governing the operation of Palo Verde as well as a request by the Company to recover during 1990 approximately $2 million of under-recovered fuel expenses. The Company subsequently amended its request to reduce the performance penalty to approximately $1.5 million. On May 21, 1990, the New Mexico Commission issued its final order accepting the Company's revised performance penalty of $1.5 million and granted the Company's requested under-recovery of fuel expenses of $2 million. The Company offset the performance penalty against the under-recovered fuel expenses.

FERC Rate Matters

The Company's rates for wholesale power sales and transmission services are subject to regulation by the FERC. The Company's sales for wholesale power make up a significant portion of the Company's operating revenues. During both 1990 and 1989, approximately 17% of the Company's electric operating revenues resulted from such sales. Rate tariffs currently applicable to certain FERC jurisdictional customers contain appropriate fuel and purchased power cost adjustment provisions designed to recover the Company's fuel and purchased power costs. Two FERC customers have fixed fuel factors approved under FERC tariffs for which no fuel reconciliation is made. Although rates to wholesale customers require FERC approval, the Company and its wholesale customers usually establish such rates through negotiations subject to such FERC approval.

The Company has a long-term firm power sales agreement with IID providing for the sale of 100 MW of firm capacity to IID through April 2002. In addition, the agreement calls for contingent capacity of 50 MW to be made available to IID beginning in 1992 and continuing through April 2002. The terms of the agreement generally provide for sales prices designed to fully recover the scheduled costs over the life of the agreement. The sales prices are generally level throughout the term of the agreement. Because of the levelized rate, costs will exceed revenues in the early years of the agreement. Amounts accrued under the terms of the agreement were $5,808,000, $7,340,000 and $7,632,000 in 1990, 1989 and 1988, respectively. Such accruals, which aggregate $22,290,000 as of December 31, 1990, are recorded as a long-term contract receivable on the Company's balance sheets.

The Company has a firm power sales agreement with TNP, providing for sales to TNP ranging from 68 MW to 79 MW through 2002, with negotiated demand charge rates for such power.

The agreements with IID and TNP settle any possible issue of the prudence of the construction costs of Palo Verde and of excess generating capacity and includes all of the Company's generation facilities in rates.

Construction Program

The Company does not intend to construct any new base load generating facilities until the end of the century. Utility construction expenditures are therefore expected to consist primarily of the cost of betterments and improvements relating to the Palo Verde Station and the cost of expanding and updating the electric transmission system and utility distribution systems. The Company's estimated cash construction costs for 1991 through 1994 set forth in the table below are approximately

$176.7 million. For a number of reasons, actual costs may vary from the construction program estimates set forth below. Such estimates are reviewed and modified from time to time to reflect changed conditions.

By Year(1) (In thousands)	
1991	$ 38,000
1992	52,100
1993	43,400
1994	43,200
Total	$176,700

By Function (In thousands)	
Production(1)	$ 72,200
Transmission	9,900
Distribution	85,700
General	8,900
Total	$176,700

(1) Does not include acquisition costs for nuclear fuel. See "Energy Sources — Nuclear Fuel."

Net utility plant at December 31, 1985 was $1,693,704,000. Gross additions to plant, including CWIP, for the five years ended December 31, 1990, totaled $602,486,000 (the largest portion of which was $398,710,000 for PVNGS). Net utility plant at December 31, 1990 (which reflects the sales of plant in the Palo Verde sale and leaseback transactions), was $1,397,146,000 (including capitalized nuclear fuel of approximately $51,424,000 leased from a nuclear fuel trust). See "Energy Sources — Nuclear Fuel."

Facilities

As described below, the Company currently has a net generating capacity of 1,497 MW, consisting of 246 MW at Rio Grande, 478 MW at Newman, 69 MW at Copper, an entitlement of 104 MW from Four Corners Units 4 and 5 and an entitlement of 600 MW from Palo Verde Units 1, 2 and 3.

Palo Verde Station

The Company has a 15.8% interest in the three 1,270 MW nuclear generating units and Common Plant at the Palo Verde Station near Phoenix, Arizona (owned as to Unit 1 and approximately 60% of Unit 3, and leased as to Unit 2 and approximately 40% of Unit 3). The participants in the Palo Verde Station include the Company and six other utilities: APS, Southern California Edison Company, PNM, Southern California Public Power Authority, Salt River Project Agricultural Improvement and Power District and the Los Angeles Department of Water and Power. Participants share costs and generating entitlements in the same proportion as their percentage interests in the generating units. APS serves as Operating Agent for the Palo Verde Station. In February 1977 and November 1978, respectively, the New Mexico Commission and the Texas Commission issued CCNs for the Company's participation in Palo Verde Station.

In August and December 1986, the Company sold and leased back all of its 15.8% undivided interest in Unit 2 and one-third of its undivided interest in certain Common Plant at Palo Verde for approximately $684.4 million cash. In December 1987, the Company sold and leased back approximately 40% of its undivided 15.8% interest in Unit 3 for approximately $250 million cash. For a description of the terms and provisions of these transactions, see Note E of Notes to Financial Statements.

Operation of each of the three Palo Verde units requires an operating license from the NRC. Full power operating licenses for Units 1, 2 and 3 were issued by the NRC in June 1985, April 1986 and November 1987, respectively. The full power operating licenses, each valid for a period of approximately 40 years, authorize APS, as operating agent for Palo Verde, to operate the three Palo Verde units at full power.

In October 1990, the NRC imposed a civil penalty in the amount of $125,000, which APS, as operating agent, subsequently paid, for a Severity Level III violation (on a scale of I to V, with Level V provides that if the Four Corners Plant loses a portion of its rights in the adjudication, the Tribe will provide sufficient water from its allocation to offset the loss.

For additional information regarding the Four Corners Plant, see "Environmental Matters."

Rio Grande Power Station

The Rio Grande Power Station, located in New Mexico adjacent to the city of El Paso, Texas, consists of three steam-electric generating units which have an aggregate capability of 246 MW when operating entirely on natural gas. When interstate natural gas at the station is curtailed, the units operate primarily on fuel oil. See "Energy Sources."

Newman Power Station

The Newman Power Station, located in El Paso, Texas, consists of three steam-electric units with an aggregate capability of 266 MW and one combined-cycle unit with a capability of 212 MW. The units regularly operate on natural gas, but are also capable of operating on fuel oil. See "Energy Sources."

Copper Power Station

The Copper Power Station, consisting of a 69 MW combustion turbine capable of operating on fuel oil or natural gas and used for peaking purposes, was placed in service in June 1980 on a leased site in El Paso, Texas. The station has been classified under the Fuel Use Act as an existing facility, which allows the station to burn natural gas. Since such classification, the station has operated primarily on intrastate natural gas. See "Energy Sources — Natural Gas."

Transmission Lines

In December 1989, the Company completed construction of a 313 mile long, 345 KV, transmission line and associated substation equipment, known as the AIP, which provides access to the Company's generation entitlement to the Palo Verde Units and the Four Corners Plant. The transmission line originates at the Springerville Generating Station in Springerville, Arizona, and terminates at the Company's Rio Grande Power Plant in Dona Ana County, New Mexico (northwest of El Paso). AIP enables the Company to import low cost energy from the Arizona and New Mexico power grid, enhances the Company's transmission system reliability, better equips the Company to meet future strategic generating resource mix requirements and further enables the Company to benefit from economy energy purchases.

The Company owns a 230-mile, 345 KV transmission line from the Newman Power Station to Albuquerque, New Mexico, at which point the Company's entitlement from Four Corners is delivered from 150 miles of transmission lines owned by PNM. This 345 KV transmission line regularly carries power from Four Corners where the Company has a major interconnection with the other five participants in Four Corners. The Company also owns an undivided interest in a 200-mile, 345 KV transmission line from Newman across southern New Mexico to Greenlee, Arizona. These lines provide interconnections with Tucson Electric Power Company to provide transmission for the Company's entitlements from Four Corners and Palo Verde and also provide added stability, flexibility and reliability to the Company's system.

Environmental Matters

Four Corners Plant. Units 4 and 5 of Four Corners have operated for several years under variances granted by the NMEID relating to the emission of nitrogen oxides. The most recent variances were granted on December 18, 1987, to allow adequate time for the installation of additional equipment intended to achieve compliance with existing emissions limitations without adverse operational impacts. Installation of additional equipment on Unit 4 was completed prior to the expiration of the variance, and monitoring by APS, as Operating Agent, indicates that this unit is now operating in compliance with existing emissions limitations. A variance was granted through September 30, 1991 for Unit 5. The Company estimates that its share of costs relating to the installation of additional equipment will be immaterial.

Santa Fe Substation. In August 1990, in the course of replacing an underground storage tank and capping several unused water wells located at the Company's Santa Fe substation site in El Paso, Texas, the Company discovered the presence of oil within one of the water wells. Upon testing the water/oil residue, the Company detected the presence of PCBs in the residue. In accordance with the rules and regulations of the TWC, the Company notified the TWC of the presence of PCBs. The basis for the presence of the oil and the PCBs in the well is not known. By letter dated September 4, 1990, the TWC requested that the Company perform a contamination site assessment study and report its findings to the TWC. The site assessment has not been completed; however, preliminary reports indicate the presence of PCBs and TPHs in the soil and water. Based upon testing results obtained by the Company to date, the Company believes that the PCB contamination is relatively contained, but the presence of TPHs appears to be more extensive. Although the Company initially believed that the TPHs resulted from the use of the property as a coal gasification plant in the late nineteenth century, analysis of the TPHs indicates that those present are of the type found in oil rather than the type associated with the by-products of coal gasification. The extent of contamination and the nature of the required remediation cannot be determined at this time.

In August 1989, the TWC notified the Company that the TWC, together with the EPA, had conducted a study of 33 coal gasification sites in Texas. The TWC stated that while by-products from coal gasification plants may or may not result in hazardous substances being present in the soil, no apparent threat to human health, safety or the environment exists, and the TWC required no action, with respect to the coal gasification plant at the Santa Fe substation site. One of the factors relied upon by the TWC is that the area is covered by buildings and asphalt. Nevertheless, testing for the presence of TPHs at the Santa Fe substation could ultimately result in a requirement for remediation of the entire site, including the coal gasification plant, in which event the total cost to the Company could exceed $2 million. Such extensive remediation could be required if the on-going site assessment and remediation disturb the asphalt in the area to the extent that the TWC no longer is comfortable with its earlier appraisal of the coal gasification plant. Based on a limited amount of testing, the Company does not expect the TWC to require remediation of the entire area.

The Company does not believe that any penalties or fines will be assessed against the Company as a result of these matters.

Rio Grande Power Station. The Company has notified NMEID of a fuel oil spill of approximately 510 barrels of light grade fuel oil which occurred at the Rio Grande power plant in August of 1986. Company personnel had not previously determined this spill to be a significant problem; however, continued observation of an oily substance on standing rainwater caused the commencement of preparations for a site assessment. The Company has obtained the services of a contractor to perform the assessment. Because the location of the spill is close to the Rio Grande River, and the depth of surface water is estimated to be between four and seven feet below ground level, the spill may have adversely affected the water. The New Mexico Water Quality Act provides for a potential penalty of $1,000 for each day of violation, which for a four-year period could result in a penalty of approximately $1.5 million. The Company does not believe that a fine of such magnitude will be assessed. Potential clean-up costs cannot be estimated until a site assessment has been finished.

Clean Air Act Amendments of 1990. On October 27, 1990, Congress passed the Clean Air Act Amendments of 1990 (the "Clean Air Act"), and the President signed the Clean Air Act on November 15, 1990. The Clean Air Act addresses, among other things, "acid rain," toxic air pollutants, and the nonattainment of national ambient air quality standards. The Company has initiated its analysis of the effect of the Clean Air Act on the Company. Such analysis is not complete, therefore, the Company is unable to assess the ultimate effect of the Clean Air Act on the Company.

Energy Sources

General

Since 1985, the Company's energy mix has generally consisted of natural gas, coal and purchased power. Beginning in 1986, uranium became a part of the Company's energy mix. This, in combination with lower natural gas costs, resulted in decreases in the Company's average yearly system energy cost. The following table lists the percentage contribution of coal, gas, uranium and purchased power to the total energy mix of the Company and the average cost to the Company in cents per KWH.

	Uranium		Gas		Coal		Purchased Power	
	Percent of Energy Mix	Average Cost	Percent of Energy Mix	Average Cost	Percent of Energy Mix	Average Cost	Percent of Energy Mix	Average Cost
1986	7%	.98¢	30%	2.36¢	13%	1.01¢	50%*	2.30¢
1987	12	.96	32	2.10	14	1.04	42*	2.04
1988	40	1.06	30	2.21	13	1.00	17*	2.47
1989	17	.99	48	2.09	12	1.05	23*	2.37
1990	36	1.10	35	2.29	12	1.09	17*	2.30

* Prior to rate making treatment of the Company's investment in Palo Verde as described in "Regulation," the Company included under purchased power the major portion of energy generated by Palo Verde.

For a discussion of the recovery by the Company of its fuel costs, either in base rates or through fuel adjustment clauses, see "Regulation — Texas Rate Matters — Texas Recovery of Fuel Expenses," "— New Mexico Rate Matters" and "— FERC Rate Matters."

The Company's local generating units are subject to the requirements of the Fuel Use Act, as amended. Under such Act, the Company may continue to burn natural gas in its existing generating units for the life of the units, subject to compliance with a DOE approved energy conservation plan filed by the Company. The Company will continue its conservation programs in the areas of customer assistance, public information and operating efficiency.

Nuclear Fuel

The fuel cycle for Palo Verde is comprised of the following stages: (1) the mining and milling of uranium ore to produce uranium concentrates; (2) the conversion of uranium concentrates to uranium hexaflouride; (3) the enrichment of uranium hexaflouride; (4) the fabrication of fuel assemblies; (5) the utilization of fuel assemblies in reactors; and (6) the storage of spent fuel and the disposal thereof. The Palo Verde participants have made arrangements to obtain quantities of uranium concentrate anticipated to be sufficient to meet operational requirements through 1997. Existing contract options could be utilized to meet approximately 30% of these requirements from 1998 through 2000. Spot purchases on the open market will be made as appropriate in lieu of any uranium which might be obtained pursuant to the contract options. The Palo Verde participants have contracted for all conversion services required through 1992. The Palo Verde participants have also contracted for a significant portion of conversion services required in 1993 and 1994, with options to contract for the remaining requirements in 1993 and 1994 and for all of the requirements in 1995 and 1996. The Palo Verde participants, including the Company, have an enrichment services contract with DOE that obligates DOE to furnish the enrichment services required for the operation of the three Palo Verde units over a term expiring in November 2014, with the annual option to terminate each year of the contract separately with ten years' notice, which option APS, on behalf of the Palo Verde participants exercised in 1989 for the year 1999. In addition, existing contracts will provide fuel assembly fabrication services for at least ten years from the operation date of each Palo Verde unit and, if options are exercised, for approximately fifteen additional years.

Spent fuel storage facilities at Palo Verde have sufficient capacity to store all fuel expected to be discharged from normal operation of all of the Palo Verde units through at least the year 2004. Pursuant to the Nuclear Waste Policy Act of 1982, as amended in 1987 (the "Act"), DOE is obligated to accept and dispose of all spent nuclear fuel and other high-level radioactive wastes generated by all domestic power reactors. The NRC, pursuant to the Act, also requires operators of nuclear power reactors to enter into spent fuel disposal contracts with DOE. APS, on behalf of itself and the other Palo Verde participants, has executed a spent fuel disposal contract with DOE. The Act also obligates DOE to develop the facilities necessary for the permanent disposal of all spent fuel generated and to be generated by domestic power reactors and to have the first such facility in operation by 1998 under prescribed procedures. In November 1989, DOE reported that such permanent disposal facility will not be in operation until 2010, seven years later than previously reported. As a result, under DOE's current criteria for shipping allocation rights, Palo Verde would begin spent fuel shipments to the DOE disposal facility in 2017. The Company believes that alternative interim spent fuel storage methods will be available for use by Palo Verde until DOE's scheduled shipments from Palo Verde begin.

Pursuant to the Participation Agreement among the Palo Verde participants, the Company has an undivided interest in nuclear fuel purchased and to be purchased in connection with Palo Verde. The Company has a nuclear fuel purchase contract with an independent trust, a portion of which is not reflected in the Company's balance sheets. The amount of such commitment not reflected at December 31, 1990 was $14,800,000. The trust purchases nuclear fuel and incurs all costs in connection with the acquisition of the fuel for use by the Company at Palo Verde. The Company has the option of either purchasing the fuel from the trust or purchasing the heat generated by the fuel. The Company has elected and intends to continue to elect to purchase the heat produced from the fuel in the trust as the basis for payment for fuel loadings. At December 31, 1990, the aggregate investment of the trust in such nuclear fuel and related materials was approximately $81,700,000, including approximately $66,900,000 for fuel loaded at Palo Verde. To finance its obligations, the trust has a credit agreement providing for borrowings up to $125,000,000. The borrowing facilities under the credit agreement are supported by a bank letter of credit in the amount of $125,000,000. The credit agreement will terminate January 8, 1993, unless the credit bank rescinds its notice of termination prior to that date and the trust consents to such rescission. Absent rescission of the notice of termination, the Company will be required to refinance or retire at January 8, 1993 the trust's obligations. The Company is, under the purchase contract with the trust, required to pay the trust upon termination of the purchase contract, an amount equal to the net investment of the trust in nuclear fuel plus an amount, if any, necessary for the trust to pay in full amounts owing on the trust's revolving line of credit. See Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources."

Natural Gas

The Company is supplied with natural gas from both interstate and intrastate pipeline systems. The interstate pipeline owned by El Paso Natural Gas Company ("EPNG") provides the Company's Rio Grande Station with spot natural gas and/or contract commodity gas. Meridian Oil Transportation ("MoTrans") supplies the Company's Newman and Copper Stations with a firm natural gas supply made up of both intrastate and spot natural gas purchases.

In 1990, the Company's interstate natural gas requirements consisted solely of spot natural gas supplied by various suppliers. Negotiations continue on the Company's commodity gas contract with EPNG which terminated in December 1987. The Company and EPNG expect to reach a new agreement in 1991. In the interim, EPNG continues to transport spot natural gas for the Company pursuant to transportation agreements with EPNG, and provides commodity gas (as required) to the Company under the original Certificate of Service filed with the FERC.

The intrastate natural gas requirements at Copper and Newman are supplied and transported pursuant to an intrastate natural gas contract with MoTrans. In addition, interstate natural gas can be supplied to Newman Power Station, which allows for a back-up natural gas supply when operational constraints on the intrastate gas system dictate the need for an alternate fuel supply. In December 1990, the Company successfully concluded negotiations with MoTrans and signed a contract to supply the Company's intrastate gas requirements through December 31, 1995. The new agreement provides the Company continuing flexibility in scheduling its natural gas requirements while allowing for the maximization of the use of inexpensive economy purchase power and generation from its remote resources Four Corners and Palo Verde.

During 1990, the Company experienced supply curtailments on its interstate and intrastate natural gas system due to pipeline pressure problems caused by severe winter weather conditions in various parts of the nation. The impacts of the curtailments were minimal because the Company was able to shift load to other generating plants or purchase off-system power. The Company does not expect any significant curtailments during 1991 with respect to either interstate or intrastate gas supplies.

Coal

The Company believes that the Four Corners Plant has sufficient reserves of low sulfur coal (the sulfur content of which is currently running at 0.8%) committed to the plant to continue operating it for its useful life. APS purchases all of the coal which fuels the Four Corners Plant from a coal supplier with a long-term lease of coal reserves owned by the Tribe. In 1990, the prices paid for coal were relatively stable, although applicable contract clauses permit escalations under certain conditions.

Preferred Stock Tax Indemnity

In July 1989, the two corporations which are the beneficial owners of the Company's 11.375% preferred stock, aggregate par value $50 million, notified the Company that the IRS had proposed to disallow those holders the dividends received deduction taken by them on their 1985 income tax returns with respect to the dividends they received on that stock. At the same time the IRS also made the same proposed disallowance to the beneficial owners of a number of preferred stock issues of other utilities. Under an agreement the Company entered into on issuance of the shares in 1984, the Company has agreed to indemnify the beneficial owners for loss of the dividends received deduction by reason of IRS action. The beneficial owners are contesting the proposed disallowance as required by the agreement.

In January 1990, the beneficial owners provided the Company a schedule of indemnity payments that would be due if the IRS were to prevail. By the owners' calculation, an indemnity payment of $28,637,989 for additional taxes, penalties and interest to September 30, 1989 ($31,362,852 if interest is extended to December 31, 1990) would be due for all dividends paid from January 1, 1985, through October 1, 1989, and additional indemnity payments with respect to dividends due thereafter, paid as the quarterly dividends are paid, would total $6,848,697. Under the indemnity agreement, the owners can require the Company to escrow, during the pendency of the IRS contest, the indemnity payments that would be owing if the IRS prevails, because the Company's First Mortgage Bonds are not rated at specified levels. To date the owners have not required an escrow. The escrow, if established, would be invested for the account of the Company.

Under the Company's interpretation of the indemnity agreement, the Company is required to make indemnity payments, assuming the IRS prevails, only for dividends paid after the Company received, in July 1989, notice of the proposed IRS action, and therefore, if any escrow is required, the Company would be obligated to escrow indemnity payments only for the October 1, 1989 dividend and each quarterly dividend thereafter as it is paid. If the Company's interpretation is sustained, then, depending on how a dispute is resolved on the tax rate to be used in determining the indemnity payments, the indemnity payment or earlier escrow deposit would be $795,985, by the Company's calculation, or $1,304,826, by the owners' calculation, for the additional tax, penalty and interest to December 31, 1990, with respect to the October 1989 dividend. For the dividends paid thereafter, the indemnity payment or escrow deposit for each dividend would decrease as the preferred stock is redeemed according to its terms ($10 million a year from July 1990, to final redemption in July 1994), and would total, over the 42-month period, $6,422,136 by the Company's calculation, or $6,848,698 by the owners' calculation. Counsel to the Company believes that the beneficial owners are more likely to prevail than the IRS on the proposed disallowance of the dividends received deduction, and also believes that, if the IRS does prevail, there is substantial support for the Company's position that it is not obligated to indemnify for past dividends. If the IRS were to prevail, the Company believes its dividend and indemnity payments would be deductible as interest paid for federal income tax purposes.

Since these indemnity payments, even under the Company's interpretation, would increase the Company's pre-tax cost by more than 50 basis points, the indemnity agreement gives the Company the right to redeem all of the shares for par plus any indemnity payments due, at any time through the third dividend payment after conclusion of the IRS contest. The Company's present intention, which may change, is not to seek repurchase of the shares before conclusion of the tax contest.

Regardless of the resolution of this matter, the Company was liable for indemnity payments to the owners for additional taxes due by reason of the reduction in the dividends received deduction by the Tax Reform Act of 1986 and the Revenue Act of 1987. On June 5, 1990, the Company paid the owners a one-time indemnity payment of $1.5 million to satisfy the Company's obligations to the owners in regard to the indemnity pursuant to the Tax Reform Act of 1986 and the Revenue Act of 1987. This satisfaction of the indemnity obligation reduces the indemnity due if the IRS prevails on its proposed total disallowance of the dividends received deduction.

In September, 1989, the IRS sought technical advice on the tax issues from its National Office in Washington, D.C., using the case of the preferred stock issued by another public utility as a "test case," but a year later the IRS withdrew its request for technical advice. Recently, the IRS changed its approach in its test case, dropping the proposed disallowance of the owners' dividend received deduction and substituting, in its stead a proposed disallowance of the deduction the owners claimed for interest on the notes they issued to finance the purchase of the preferred stock, on the grounds that the leveraged purchase lacked economic substance, an elimination of the owners' dividend income that does not exceed the owners' interest expense, and a reclassification of the owners' dividend income over interest expense as taxable income not qualifying for a dividends received deduction. In March, 1991, the IRS submitted its new approach to its National Office for technical advice. A change of the IRS position in its "test case" does not necessarily mean the IRS will or can assert a similar position in the case of the owners of the Company's preferred stock. The Company's indemnity agreement does include an agreement to indemnify against additional taxes due to loss of the deduction for the interest expense, but only with respect to interest paid after the owners have notified the Company that the IRS has disallowed the deduction.

Arizona Tax Matters

Arizona Sales Tax. In 1986 and 1987, the Company entered into sale and leaseback transactions with respect to its interest in Unit 2 and 40% of Unit 3 at PVNGS. Pursuant to the leases in such transactions (the "Palo Verde Leases"), the Company is obligated to hold the lessors harmless against certain tax events. Following a recent audit by the Arizona Department of Revenue (the "ADR"), the Company was advised in September 1990 by a staff member of the ADR that the taxability of the payments under such leases could change if certain interpretations are adopted by the ADR. Currently, 8% of the property subject to the Palo Verde Leases is considered real property, and sales tax has been paid on that portion of the lease payment for all lease payments made after July 1988. The ADR may contend that (1) either all, or some portion above 8%, of the property subject to leases is real property and that sales tax was due on lease payments beginning in 1987 and/or (2) the property taxes paid on behalf of the lessors constitutes income subject to Arizona sales tax. If the ADR proposes interpretation (1) and prevails, the Company would, in the worst case, owe approximately $15.6 million in back taxes through 1990, and annual lease expenses would increase by $4.6 million for 1991 and thereafter. If the ADR proposes interpretation (2) and prevails, the Company would owe back taxes of approximately $1.3 million through 1990 and would experience increased lease expense of $.6 million annually thereafter (assuming that 100% of the lease payment is taxable). The Company has not officially been notified by the ADR that such interpretations would be sought, and it is uncertain whether these or any other interpretations will be assessed by the ADR. The Company believes it has meritorious defenses to the claims described, but no assurance can be given that the Company will prevail against such claims. The Company would seek to recover any increased expenses through rates.

Arizona Income Tax. By Notice of Proposed Correction of Income Tax dated February 9, 1990 ("Notice"), the ADR, in connection with an audit examination of the taxable years 1984 through 1987, informed the Company that the ADR has determined that the gains from the 1986 and 1987 sales of the Company's interest in Palo Verde Unit 2 and a portion of the Company's interest in Unit 3 are allocable to Arizona for state income tax purposes on the grounds that the units constitute non-business assets with a situs in Arizona, resulting, according to the ADR, in a proposed deficiency assessment, including related interest and penalties, of approximately $39.5 million ($42.5 million if interest is extended through December 31, 1990), exclusive of any net operating loss ("NOL") carryforwards. On March 28, 1990, the Company filed a protest to the proposed deficiency assessment. The Company believes Palo Verde Units 2 and 3 constituted business assets at the time of the respective sales, and, in accordance with Arizona law, it apportioned, rather than allocated, the corresponding gains in paying the Arizona income tax on the transactions.

A formal administrative hearing with the Hearing Office of the ADR was held on October 19, 1990, at which time the Hearing Officer allowed the ADR, over the Company's objections, to raise issues not contained in the ADR's Notice. The two primary issues so raised by the ADR are: (1) whether the Company properly excluded from the Arizona sales factor computation in 1986 and 1987 the gross proceeds from the sale and leaseback transactions involving Palo Verde Units 2 and 3, respectively; and (2) whether carryovers of Arizona NOL generated in the taxable years 1979 through 1983 can be used by the Company to offset Arizona taxable income in the taxable years 1984 through 1987. The Company does not expect that the Hearing Office will issue an order reflecting its decision on the case issues until mid to late summer 1991. The Company will appeal to the Director of the ADR any adverse determination by the Hearing Office, and will litigate any issues not satisfactorily resolved through the administrative review process. The Company does not expect to incur any material liability in respect of the proposed determination of the ADR.

Arizona Property Tax. On June 29, 1990, the Arizona legislature enacted legislation effective December 31, 1989, which requires the school district in which Palo Verde is located to levy additional property taxes on utility and mining property. On December 20, 1990, the Palo Verde participants, including the Company, filed a lawsuit in the Arizona Tax Court, a division of the Maricopa County Superior Court, against the ADR, the Treasurer of the State of Arizona, and various Arizona counties, claiming, among other things, that portions of the new tax law are unconstitutional. The Company cannot currently predict the outcome of this matter.

Executive Officers of the Registrant

Name	Age	Current Position and Business Experience
David H. Wiggs, Jr.	43	Chairman of the Board since May 1989; Chief Executive Officer since March 1989; President and a Director since January 1988; Chief Operating Officer from January 1988 to March 1989; for more than 5 years prior to January 1988, chief regulatory legal counsel and shareholder in Kemp, Smith, Duncan & Hammond, P.C., El Paso, Texas.
Curtis L. Hoskins	53	Executive Vice President and Chief Operating Officer since May 1990; Executive Vice President, PacifiCorp (Utah Power and Light Division), Salt Lake City, Utah, from January 1989 to April 1989; Executive Vice President (Administration), Utah Power and Light Company, Salt Lake City, Utah from June 1982 to January 1989.
William J. Johnson	49	Senior Vice President — Financial Group since December 1987; Chief Financial Officer since December 1986; Vice President — Treasurer from December 1986 to December 1987; Vice President — Controller from May 1984 to December 1986.
William W. Royer	46	Senior Vice President since January 1990; Senior Vice President — Corporate Services from January 1988 through March 1989; General Counsel from March 1981 to January 1988; Vice President from December 1985 to January 1988; President, Franklin Land from March 1989 to January 1990; President, Triangle Electric Supply Company, El Paso, Texas (see Item 3) from October 1988 to March 1989.
Ignacio R. Troncoso	44	Senior Vice President — Operations Group since May 1989; Senior Vice President — Transmission and Distribution/Engineering from December 1987 to May 1989; Vice President — Engineering, Transmission and Distribution from May 1982 to December 1987.
Lawrence M. Downum, Jr.	52	Vice President — Corporate Services since July 1989; Vice President since December 1983.
Eduardo A. Rodriguez	35	Corporate Secretary since January 1989; General Counsel since February 1988; Assistant Secretary from June 1986 to January 1989; Assistant General Counsel from December 1984 to February 1988.
Frederic E. Mattson	46	Vice President — Power Supply since June 1989; Assistant Vice President — Energy Resource and Planning from August 1988 to June 1989; Manager — Resource Development/Contracts from March 1981 to August 1988.
J. Frank Bates	41	Vice President — Customer Services since June 1989; Assistant Vice President — Customer Services from November 1987 to June 1989; Manager — Engineering Department from September 1983 to November 1987.

Name	Age	Current Position and Business Experience
John E. Droubay	52	Vice President and Treasurer since September 1990; President, Chief Executive Officer and Chairman of the Board, Energy Mutual Insurance Company and Electric Life Insurance Company, Salt Lake City, Utah, from May 1989 to September 1990; Treasurer, Utah Power & Light Company, Salt Lake City, Utah, from May 1981 to January 1989.
Russell G. Gibson	38	Controller since September 1989; for more than 5 years prior thereto, partner and member, Coopers & Lybrand (certified public accountants).
Gary R. Hedrick	36	Vice President — Financial Planning and Rate Administration since September 1990; Treasurer from February 1988 to September 1990; Assistant Vice President, Finance from February 1990 to September 1990; Assistant Treasurer from June 1986 to December 1986; Manager — Financial Planning from October 1985 to December 1986; Vice President, Treasurer and Chief Financial Officer of PasoTex from December 1986 to February 1988; Treasurer of Franklin Land from November 1986 to February 1988.
John C. Horne	42	Vice President — Transmission Systems Division since August 1989; Group Manager — Transmission and Distribution from November 1987 to August 1989; Manager — Systems Operations from June 1985 to November 1987.
Robert C. McNiel	44	Vice President — New Mexico Division since December 1989; Assistant Vice President — New Mexico Division from July 1989 to December 1989; Manager — Energy Marketing from February 1988 to July 1989; Manager — Customer Accounting from November 1985 to February 1988.
James A. Mayhew	36	Vice President — Rate and Energy Utilization since September 1990; Vice President — Rates & Regulatory Affairs from August 1989 to September 1990; Assistant Vice President — Rates & Regulatory Affairs from June 1989 to August 1989; Manager — Rates & Regulation from April 1987 to June 1989; Assistant Manager — Rates & Regulation from June 1986 to April 1987; Supervisor — Rate Research from March 1982 to June 1986.

The executive officers of the Company are elected no less often than annually and serve at the discretion of the Board of Directors.

Operating Statistics

	December 31, 1990	1989	1988
Operating Revenues (In thousands):			
Retail:			
Residential	$ 126,240	$ 122,598	$ 112,957
Commercial and industrial, small	121,917	117,272	105,166
Commercial and industrial, large	44,295	42,250	35,575
Sales to public authorities	64,773	63,886	57,240
Provision for refund	(331)	62	(1,641)
Other	2,847	2,438	4,891
	359,741	348,506	314,188
Wholesale:			
Sales for resale	72,760	77,742	67,919
Total operating revenues	$ 432,501	$ 426,248	$ 382,107
Number of customers (End of year):			
Residential	218,753	214,664	209,550
Commercial and industrial, small	22,135	21,762	21,069
Commercial and industrial, large	60	52	39
Other	2,788	2,659	2,543
Total	243,736	239,137	233,201
Average annual use and revenue per residential customer:			
KWH	6,082	6,124	6,025
Revenue	$ 582.35	$ 577.60	$ 546.13
Average revenue per KWH:			
Residential	9.57¢	9.43¢	9.07¢
Commercial and industrial, small	8.21	8.08	7.52
Commercial and industrial, large	5.65	5.53	5.10
Energy supplied, net, KWH (In thousands):			
Generated	5,277,127	4,753,236	4,904,854
Purchased and interchanged	1,086,126	1,446,063	969,793
Total	6,363,253	6,199,299	5,874,647
Energy sales, KWH (In thousands):			
Retail:			
Residential	1,318,471	1,299,768	1,246,081
Commercial and industrial, small	1,484,207	1,450,817	1,397,913
Commercial and industrial, large	784,177	763,650	697,758
Sales to public authorities	954,441	947,948	908,238
	4,541,296	4,462,183	4,249,990
Wholesale:			
Sales for resale	1,442,799	1,411,162	1,271,366
Total sales	5,984,095	5,873,345	5,521,356
Losses and company use	379,158	325,954	353,291
Total	6,363,253	6,199,299	5,874,647
Native system:			
Peak load, KW	920,000	916,000	840,000
Net generating capacity for peak, KW	1,497,000	1,497,000	1,497,000
Load factor	61.6%	61.0%	63.0%
Total system:			
Peak load, KW	1,098,000	1,076,000	1,002,000
Net generating capacity for peak, KW	1,497,000	1,497,000	1,497,000
Load factor	66.7%	67.0%	67.3%

Item 2. Properties

The principal properties of the Company are described in Item 1 of this report, and such descriptions are incorporated herein by reference thereto. Transmission lines are located either on private rights-of-way, easements or on streets or highways by public consent. Reference is made to Note J of Notes to Financial Statements for information regarding encumbrances against the principal properties of the Company.

Item 3. Legal Proceedings

First Service Life Litigation

Pending Actions Involving the Company's Collateral. On September 26, 1988, the Company filed a declaratory judgment action in the 345th Judicial District Court, Travis County, Texas, against First Service Life Insurance Company, a life insurance company organized under the laws of the Cayman Islands ("First Service"), and R. B. Ashworth, as Conservator for the affairs of First Service under the Texas Insurance Code for a determination that (i) the Company has legal, valid, duly perfected and enforceable security interests in certain collateral (the "Collateral") granted to the Company by First Service to secure payment of certain annuities purchased by the Company from First Service, the present balance of which is approximately $20 million; and, (ii) that events of default have occurred under the collateral security documents pertaining to these annuities, which entitle the Company to enforce its security interests. On May 27, 1988, the Company notified First Service that First Service was in default under the annuities and the collateral agreements and that the Company intended to enforce its security interests. The Conservator, who was appointed by the Texas Commissioner of Insurance in early June, 1988, notified the Company that First Service might not be in default, expressed doubt as to the validity and enforceability of the security interests held by the Company and demanded the Company return to the Conservator all of the Collateral and desist and refrain from proceeding with enforcement and any other interference with the conservatorship and the conservatorship proceedings.

On September 29, 1988, the Conservator, in conjunction with his answer and denial of the Company's declaratory judgment action, countersued the Company on behalf of First Service, and two affiliated corporations, First Service Life, a Turks & Caicos Corporation ("FSL") and Knickerbocker Life Insurance Company ("Knickerbocker"), for actual damages of at least $50 million, plus punitive damages of at least $300 million. The Conservator's counterclaim seeks (i) a temporary and permanent injunction against the Company's enforcement of its security interests in the Collateral, (ii) an accounting from the Company as to all payments on and transfers of property to the Company from First Service with respect to the Company's annuity investment, (iii) a declaratory judgment that the Company's security interests are illegal and unenforceable under the Texas Insurance Code, and that the sale and purchase of the annuities was an illegal transaction under the Texas Insurance Code by a company doing business in Texas without authorization; and, (iv) disgorgement by the Company of all payments on its annuities and all collateral therefor. The counterclaim alleges several causes of action against the Company including principally fraud, conversion and breach of duty of good faith and fair dealing (based upon an alleged affiliate or "insider" relationship between the Company and First Service).

On December 1, 1988, a receiver (the "Receiver") was appointed for First Service, and on December 13, 1988, the Receiver in his capacity for First Service was substituted as a party for the Conservator. The Company then filed a Plea in Intervention to the Receivership Proceedings to protect the interest of the Company. On January 18, 1989, the Receiver was appointed as receiver for FSL as well. On May 5, 1989, the Receiver was appointed as receiver for Knickerbocker. On July 6, 1989, the Receiver, in his capacity as receiver for Knickerbocker only, non-suited without prejudice his claims against the Company.

On February 16, 1990, the Receiver joined as parties defendant Maury Page Kemp, Jean Kemp, the accounting firm of Coopers & Lybrand, and the law firm of Kemp, Smith, Duncan & Hammond, which serves as general counsel to the Company.

Although only preliminary discovery has been conducted, the Company's legal counsel, Small, Craig & Werkenthin, P.C., Austin, Texas, has reviewed the basic facts of the case with the Company's management and other parties familiar with various aspects of the transactions involved in the litigation, examined documents and records of the Company and other parties which relate to such transactions, and evaluated the allegations against the Company made in the counterclaim. Based upon its preliminary evaluation and investigation of the case to date, and subject to the results of discovery, counsel believes that it is more likely than not that the outcome of the litigation will be favorable to the Company.

The Company believes that the Company's security interests in the collateral are valid and enforceable, and the Company intends to recover amounts owed to it on the annuities through enforcement of its rights to the collateral. The Company strongly denies the allegations of the counterclaim, believes the counterclaim is without merit and intends to vigorously defend against it. At June 30, 1989, the Company recorded a provision for loss of $7 million based upon the value of the collateral. The Company has made no provision for loss for the effects, if any, of the ultimate outcome of the litigation.

Claims by Annuitants. On October 16, 1989, the case of *Pedro Meneses, et al. v. Maury Page Kemp, et al.*, Civil Action No. EP-89-CA-374H, was filed in the Western County of Texas, El Paso Division. That action was dismissed in May of 1990 without prejudice to refiling.

On May 16, 1990, Beatrice Meneses, and certain other parties filed their Plea in Intervention in *Pedro Meneses v. First Financial Savings Association of El Paso, et al.* in the County Court of El Paso, Texas, Cause No. 88-9254. The parties and allegations made in this case are substantially similar to the case previously filed and dismissed in the Western District of Texas. Essentially, the case was dismissed from federal court and refiled in state court to obtain a different forum. The plaintiffs are allegedly holders of annuities purchased from First Service and/or Knickerbocker and/or Security Southwest Life Insurance Company (the "Annuitants"). The defendants include the beneficial principal shareholders and officers and directors of First Service and Knickerbocker, certain affiliated companies of the principal beneficial shareholders of First Service and Knickerbocker, the Company, its former subsidiaries, PasoTex and Franklin, the accounting firm of Coopers & Lybrand, the law firm of Kemp, Smith, Duncan & Hammond, which serves as general counsel to the Company, and two individual attorneys who are shareholders in such firm, one Tad R. Smith, formerly a director of the Company.

The Company and other defendants removed the case to the Unites States District Court for the Western District of Texas, El Paso Division, on June 11, 1990, Civil Action No. EP-90-CA-247H (hereinafter referred to as the "RICO Action"). The RICO Action alleges that the defendants violated the Racketeer Influenced and Corrupt Organizations Act ("RICO"), conspired to violate RICO, violated Federal and Texas securities laws, committed common law fraud, civil conspiracy to defraud, and asserts violations of the Texas Deceptive Trade Practices Act, the Texas Insurance Code and the Texas Penal Code. The claims made against the Company and its former subsidiaries are based upon allegations that the Company controlled and/or conspired with First Service. The Plaintiffs are seeking damages in the amount of their lost annuities, plus interest, multiplication of actual damages, punitive and exemplary damages, and attorneys' fees and costs. The complaint in the RICO Action alleges sales of annuities to the Plaintiffs in a value in excess of $11 million, and makes a claim for unspecified punitive damages and attorneys' fees.

The Company vigorously denies any liability in respect of the RICO Action and believes that all related claims are without merit. No formal discovery has been conducted by any of the parties to the RICO Action. Based upon the limited evaluation and investigation of Small, Craig & Werkenthin, P.C., Austin, Texas, the Company's legal counsel in connection with the pending litigation, such counsel believes that it is more likely than not that the ultimate outcome of the RICO Action will be favorable to the Company. The Company has made no provision for loss for the effects, if any, of the ultimate outcome of the litigation.

The RICO Action names as a defendant Billye E. Bostic, formerly an executive officer of the Company, who would be entitled to indemnity under the Company's charter, bylaws and other applicable agreements to the same extent as indemnification is afforded by the Company to all of its officers and directors with respect to service on boards of directors of other companies. However, whether Mr. Bostic will be entitled to such indemnity from the Company with regard to the RICO Action has not yet been determined and such determination will be dependent on all the facts and circumstances which may surface during the course of this litigation. Mr. Bostic has advised the Company that he denies any liability in respect of the RICO Action and believes that the claims asserted against him therein are without merit. Mr. Bostic is represented by counsel separate from the Company's counsel. While the Company is currently assuming Mr. Bostic's legal expenses, no provision for an indemnity payment, if any, is included in the 1990 financial statements.

Suit Against Directors of First Service. On February 3, 1989, the Receiver filed suit in the 345th Judicial District Court, Travis County, Texas, against certain individuals who were alleged to be directors of First Service and/or FSL, including Mr. Bostic.

The Receiver alleges that First Service engaged in the sale of annuities in Texas without authorization to do so and that such actions constituted illegal insurance transactions under the Texas Insurance Code. The Receiver further alleges that the alleged illegal sale of annuities by First Service constitutes a breach by the directors of First Service of their fiduciary duty to exercise due care in the management of the affairs of First Service and/or FSL and resulted in unspecified losses to First Service. The suit seeks actual damages of at least $33 million and, in addition, exemplary damages of at least double the actual damages. No significant discovery has been conducted at this time.

Mr. Bostic has advised the Company that he denies that he served as a director of First Service or FSL during the period of the alleged activities complained of, denies any liability in respect of the Receiver's suit and intends to vigorously defend against it. Mr. Bostic is represented by counsel separate from the Company's counsel in the First Service litigation. Mr. Bostic would be entitled to indemnity with respect to the Receiver's suit to the extent indemnification is afforded by the Company to all of its officers and directors with respect to service on certain outside boards. However, whether Mr. Bostic will be entitled to such indemnity from the Company with regard to this lawsuit has not yet been determined and such determination will be dependent on all the facts and circumstances which may surface during the course of this litigation.

Because no significant discovery has been conducted, counsel for Mr. Bostic is unable to express an opinion as to the ultimate outcome of the suit. While the Company is currently assuming Mr. Bostic's legal expenses, no provision for an indemnity payment, if any, is included in the 1990 financial statements.

Settlement negotiations have been conducted and are ongoing with a view toward a settlement which would terminate all of the above described First Service Life litigation as it relates to the Company. No formal settlement arrangement has been entered into and, at this time, the Company is unable to determine whether a settlement can be achieved or what the terms of any such settlement would be.

There are numerous parties who purchased annuities from First Service, not included as parties to these lawsuits, who may assert additional claims, similar in nature to the claims asserted by the current parties against the Company. These claims, if asserted, could result in additional suits against the Company.

P & C Lacelaw Trust Litigation

On September 26, 1990, P & C Lacelaw Trust ("Lacelaw") filed suit in the 346th District Court of El Paso County, Texas against the Company, Franklin, a former subsidiary of the Company, and DDG, Inc. ("DDG"), the party which purchased all of the capital stock of Franklin from the Company in January 1990. Lacelaw alleges that Franklin acted in bad faith and participated in self-dealing in connection with Franklin's management, as general partner, of a limited partnership between Franklin and Lacelaw, the purpose of which was to acquire, own and operate an office building in downtown El Paso. Lacelaw further alleges that the Company is responsible for the actions of Franklin because Franklin was the alter ego of the Company and that the Company breached fiduciary duties to Lacelaw in connection with the mismanagement and self-dealing by Franklin and through the sale of Franklin to DDG. Lacelaw seeks a declaratory judgment that the Company is a general partner in the partnership; a judgment declaring Lacelaw's rights as a limited partner; an accounting of all financial transactions involving the partnership; and a dissolution of the partnership. Lacelaw alleges actual damages of $3,200,000 and punitive damages of at least $10,000,000. The Company vigorously denies any liability with respect to this lawsuit and believes that the claims are without merit. Investigation and evaluation of the suit by counsel for the Company is in its preliminary stages and only a minimal amount of discovery has been conducted; therefore, the outcome of the suit cannot be determined at this time.

Other Legal Proceedings

Information regarding legal proceedings relating to Palo Verde, Four Corners, rates and regulation, environmental matters, preferred stock tax indemnities and certain Arizona tax matters is described under the subcaptions "Regulation," "Facilities," "Environmental Matters," "Preferred Stock Tax Indemnity" and "Arizona Tax Matters" under "Business" in Item 1 of this report and is incorporated herein by reference thereto.

The Company is a party to various other claims, legal actions and complaints, the ultimate disposition of which, in the opinion of management, will not have a material adverse effect on the operations or financial position of the Company.

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable.

PART II

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters

The Company's common stock is traded in the over-the-counter market (NASDAQ Symbol: ELPA) and quoted on the NASDAQ National Market System. The high and low sale prices for the Company's common stock, as reported by NASDAQ, and the quarterly dividends per share paid by the Company, for the periods during 1989 and 1990 indicated below, were as follows:

	Sale Price		
	High	Low	Dividends
1989			
First Quarter	$15⅝	$11	$0.38
Second Quarter	11⅞	6½	—
Third Quarter	9⅝	7⅝	—
Fourth Quarter	10	7⅞	—
1990			
First Quarter	9⅛	8	—
Second Quarter	8⅝	6¼	—
Third Quarter	7⅜	5¼	—
Fourth Quarter	5¾	3½	—

At February 28, 1991, there were 30,171 holders of record of the Company's common stock.

In May 1989, the Board of Directors eliminated the second quarter 1989 common stock dividend. No common stock dividends have been paid since then. The Board based its decision to eliminate the dividend upon, among other things, results of operations, financial condition and cash flow. The Company believes that common stock dividends will not be resumed prior to 1993. Additionally, the terms of the Company's RCF borrowing facility prohibit the Company from paying any common stock dividend, and the Company expects that any extension of the RCF beyond its present termination date of May 31, 1991, would continue to prohibit the payment of common stock dividends. See "Management's Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources".

The Company's Restated Articles of Incorporation, the First Mortgage Indenture and certain of the supplemental indentures relating to various series of First Mortgage Bonds and one of the supplemental indentures relating to a series of Second Mortgage Bonds contain restrictions as to the payment of dividends on the common stock of the Company. At December 31, 1990, the retained earnings available for dividends on the common stock under the most restrictive of those provisions was approximately $14,577,000.

Under certain provisions of the Federal Power Act regarding the payment of dividends on capital stock, the Company would, as those provisions are interpreted by the staff of the FERC, be allowed to pay dividends on its capital stock only out of retained earnings. Although the Company does not believe it is probable that significant additional write-offs from regulatory disallowances will occur, if such write-offs do occur and result in a deficit in the Company's retained earnings account, the Company would, under the FERC staff interpretations, be required to suspend the payment of dividends, and as a result sinking fund payments, on its preferred stock until the deficit is eliminated. The Company could, with the approval of the Company's common shareholders, effect an accounting reorganization of its common stock equity account to eliminate such deficit. Earnings generated after the elimination of such deficit would be an available source for the payment of dividends on capital stock. See "Regulation — Texas Rate Matters — Palo Verde Unit 3."

Additionally, depending upon the Company's ongoing assessment of its liquidity condition, and in particular, the outcome of Docket 9945, there can be no assurance that the Board of Directors will not at some future point have to consider the reduction or elimination of the preferred stock dividends, and as a result sinking fund payments.

Item 6. Selected Financial Data

As of and for the years ended December 31:

	1990	1989	1988	1987	1986
	(In thousands except per share data)				
Operating revenues	$ 432,501	$ 426,248	$ 382,107	$ 337,263	$ 318,262
Operating income	44,799	56,551	81,533	92,592	89,126
Income (loss) from continuing operations before cumulative effect of change in accounting method	(21,864)	1,956	63,877	47,431(1)	98,715
Income (loss) from continuing operations before cumulative effect of change in accounting method per weighted average shares of common stock	(0.96)	(0.28)	1.48	0.98(1)	2.41
Dividends declared per share of common stock	—	0.38	1.52	1.52	1.52
Total assets	1,808,645	1,769,518	1,799,949(2)	2,275,573	2,194,418
Additions to utility plant, before allowance for equity funds used for construction	68,823	125,644	79,845	61,246	136,598
Long-term, financing and capital lease obligations	773,517	710,078	579,129(2)	777,718	831,921
Preferred stock — redemption required	79,360	100,710	108,460	110,610	115,710
Common stock equity	371,690	404,309	533,898	573,619	603,291

(1) Includes $24.4 million after-tax write-off for regulatory disallowance of plant costs and $17.6 million charge for realized and unrealized investment losses.

(2) The reduction in 1988 from 1987 is a result of the Company's decision to discontinue and dispose of its non-utility operations.

The selected financial data should be read in conjunction with the Financial Statements, the Notes to Financial Statements, including Note P which describes the Company's discontinuation of its non-utility investments and operations, Management's Discussion and Analysis of Financial Condition and Results of Operations, and Item 1 — "Regulation" contained elsewhere in this report.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Liquidity and Capital Resources

The Company's liquidity condition is primarily affected by two factors. First, escalating operating expenses, consisting primarily of operation and maintenance expenses of the Palo Verde Station and of Arizona property taxes, have adversely affected the operation of the Company's Texas and New Mexico rate moderation plans due to the fixed level of cash rate increases provided under such plans. Second, the Company continues to finance the costs of owning and operating Unit 3, which began commercial operation in January 1988, but will be considered for the first time for inclusion in Texas rates in Docket 9945, which is expected to be concluded in the fourth quarter of 1991. See "Regulation — Texas Rate Matters" and "— New Mexico Rate Matters", "Arizona Tax Matters — Arizona Property Tax" and "— Results of Operations" in this report.

As discussed below, the Company's liquidity is dependent upon its access to adequate sources of external financing. The Company's access to external financing is ultimately dependent upon an outcome of Docket 9945 which provides sufficient operating revenues, earnings and cash flows, including a return on and recovery of the Company's plant investment in PVNGS Unit 3. Although the Company believes it is entitled to the rate relief sought in Docket 9945, the outcome of the Docket cannot presently be determined. See "Regulation — Texas Rate Matters Palo Verde Unit 3." As a result of this uncertainty, the Company's independent auditors have expressed that substantial doubt exists about the Company's ability to continue as a going concern.

The Company's financing capability has been significantly limited due to the cumulative effect of past rate orders, primarily under its Texas rate moderation plan, which have included substantial regulatory disallowances, resulting in an erosion of common equity, and revenue increases substantially less than the Company's revenue requirements, which have reduced phase-in deferrals. See "Regulation — Texas Rate Matters — Rate Moderation Plan — Palo Verde Units 1 and 2" and "— Results of Operations".

The Company will be required to finance in 1991 all of the following: $38.0 million for construction expenditures, $95.6 million for long-term debt maturities and preferred stock redemptions and $44.3 million for existing and requested regulatory deferrals. The 1991 financing requirements assume rate relief in Docket 9945 effective late in the fourth quarter of 1991. The impact of such rate relief in 1991 would not, therefore, be significant. However, the Company may seek to place a portion of its requested cash rate relief into effect under bond, subject to refund, as of mid summer, which, if implemented, would have a favorable impact upon 1991 financing requirements.

The Company's current financing plan for 1991 contemplates secured long-term financings of $75.0 million (to be applied to reduce the then outstanding short-term borrowings under the RCF or a similar facility replacing the RCF), short-term borrowings under the RCF of $102.9 million and an extension of the May 31, 1991 maturity of the debt owed by the Company's fuel oil trust through a period of time corresponding to the extension period of the RCF (see discussion below). The Company believes, but has no assurance, that, assuming the RCF is extended through November 1991 as discussed below, the bank lender to the fuel oil trust will agree to the extension of the maturity of the fuel oil trust debt. If the maturity of such debt is not extended, the Company will be required to retire the $8.7 million owed by the fuel oil trust, which would increase the Company's financing requirements in 1991.

RCF. The Company relies upon the RCF for substantially all of its short-term borrowing capacity. The RCF, which involves a syndicate of money center banks, provides for borrowings by the Company from time to time through May 31, 1991, the termination date of the RCF, of up to $150 million outstanding at any one time. Borrowings under the RCF bear interest at a floating rate based upon bank prime rate or, at the option of the Company, premiums above adjusted certificate of deposit and LIBOR rates. The May 31, 1991 termination date was set with reference to the then expected timing of the Texas Commission's order in Docket 9945. That order is now not expected until the fourth quarter of 1991. The Company is, therefore, seeking an extension of the RCF through November 1991 to continue to meet financing requirements. The Company believes that the RCF banks will grant the requested extension, but there can be no assurance that the extension will be granted. In the absence of an extension of the RCF beyond May 31, 1991, the Company would be required to seek alternative sources of financing in order to be able to continue to meet its obligations. The Company cannot predict whether such alternative financing, if required, could be obtained in the required time frame.

The Company will require short-term borrowings in 1992 under the RCF or an alternative source of financing. The Company will, therefore, request an additional extension of the RCF through at least 1992, which request the Company expects the RCF banks to consider in light of the Texas Commission's final order in Docket 9945.

It is an event of default under the RCF if the Texas Commission renders a decision with regard to the Company's investment in Unit 3 which, in the judgment of the RCF Banks, causes the Company's revenues to be insufficient to assure (1) the Company's ongoing viability, (2) its access to capital markets or (3) its ability to refinance or repay obligations when due. The outcome of Docket 9945 cannot be predicted. See "Regulation — Texas Rate Matters — Palo Verde Unit 3".

The RCF must be collateralized at all times with at least Second Mortgage Bonds of the Company in an aggregate principal amount equal to the committed amount of the RCF. At the present time, the RCF is collateralized by $100 million of Second Mortgage Bonds of the Company and $50 million of First Mortgage Bonds of the Company. As the First Mortgage Bonds are needed by the Company as a source of long-term financing, the RCF banks are required to release the First Mortgage Bonds as collateral in an amount equal to the amount of Bonds needed by the Company for the long-term financing, and the Company is required to substitute for the amount of such released First Mortgage Bonds an equal amount of Second Mortgage Bonds. See "1991 Long-Term Financing" below.

The RCF requires that the Company meet specified fixed charge and maintenance of equity ratios, maintain specified long-term debt issuance capacity and meet certain maintenance of collateral value tests.

The fixed charge ratio requires that the Company maintain a specified ratio of cash flow (as defined) to interest charges and operating lease payments. The ratio is determined quarterly and is calculated on a rolling 12 months. The Company maintained a ratio of 1.23 to 1 for the 12 months ended December 31, 1990, as compared to the required ratio for that period of 1.1 to 1. For the 12 months ending March 31, 1991, the Company is required to maintain a ratio of at least 1.1 to 1. If the RCF is extended in accordance with the Company's request described above, the Company expects the ratio for the 12 months ending June 30, 1991 and September 30, 1991 to be 1.1 to 1 and 1.15 to 1, respectively. The Company expects to remain in compliance with this required ratio through the extension period requested by the Company.

The maintenance of equity test requires that the Company maintain at all times equity (the sum of the Company's common stock equity and preferred stock *minus* intangibles *plus* losses from discontinued operations (net of taxes) recognized in 1989) of not less than 23% of the Company's capitalization (the sum of its equity (as calculated above) *plus* indebtedness of the Company and the present value of the operating lease payments on Palo Verde Units 2 and 3). On December 31, 1990, the Company met the maintenance of equity test with a ratio of 26.0% and expects to remain in compliance through the extension period.

The long-term debt issuance capacity test requires that the Company at all times have the capacity to issue mortgage bonds in an amount sufficient to repay maturing debt and provide for an additional $100 million of mortgage bond financing. Issuance capacity includes the Company's capacity to issue bonds under its First and Second Mortgage Indentures plus the unutilized committed amount of the RCF. The Company is required to maintain a ratio of capacity to required debt maturities *plus* the $100 million of at least 1 to 1. On December 31, 1990, the Company met the test with a ratio of 1.65 to 1. The Company will require and has requested from the banks a reduction in the ratio during the extension period of the RCF requested by the Company. The Company believes, but has no assurance, that the banks will, if the extension of the RCF is granted as requested by the Company, also grant the requested reduction in the issuance capacity ratio.

The collateral coverage ratio requires that the ratio of the book value of the Company's net plant in service (as defined on the Company's balance sheet minus financing and capital lease obligations and excepted property under the mortgage indentures) and construction work in progress *minus* the aggregate principal amount of First Mortgage Bond indebtedness outstanding to the aggregate principal amount of Second Mortgage Bond debt outstanding be at least 2 to 1. At December 31, 1990, the Company met this test with a ratio of 2.61 to 1. The Company expects to remain in compliance with this test through the extension period requested by the Company.

Failure to meet any of the above ratios and tests would constitute a default under the RCF, which, unless such default was waived or the ratio or test was amended so that the Company complied with the ratio or test as amended, would entitle the RCF banks to accelerate the indebtedness owing under the RCF and demand its immediate repayment.

The RCF prohibits the Company from paying any dividend on common stock.

The RCF restricts incurrence of indebtedness by the Company, other than under the RCF to (1) borrowings up to $50 million under the nuclear fuel trust credit facility described below, (2) indebtedness which is unsecured, or junior in right of security to the RCF, and which does not require principal amortization prior to the then termination date of the RCF, (3) scheduled long-term financing by the Company, including long-term financings which were required under the RCF, which the Company has successfully completed, and (4) refundings, renewals, extensions and replacements of maturing indebtedness.

Approximately $54 million was available for borrowing under the RCF at March 29, 1991.

1991 Long-Term Financing. To meet its 1991 long-term financing requirements, the Company has commitments from prospective purchasers, which are subject to certain conditions to closing, including the absence of material adverse changes in the Company's financial condition, for the purchase of $50 million of fixed interest rate First Mortgage Bonds and $25 million of fixed interest rate Second Mortgage Bonds. In order to remain within the borrowing limit of the RCF, these transactions are scheduled to and must close by June 1, 1991. The Company will be required, as a condition to the issuance of these Bonds, to obtain the approval of the RCF banks of the Company's 1991-1992 financing plans.

The $50 million of First Mortgage Bonds will be issued based upon the release by the RCF banks of the $50 million of First Mortgage Bonds presently held as collateral under the RCF. Such released Bonds will constitute retired bonds under the First Mortgage Indenture, which means that the $50 million of First Mortgage Bonds to be issued and sold this year can be issued without the Company being required to meet the net earnings test of the First Mortgage Indenture. See discussion below regarding issuance of additional First Mortgage Bonds.

The Company will be required to replace the First Mortgage Bonds released under the RCF with $50 million of Second Mortgage Bonds. The $25 million of Second Mortgage Bonds to be issued and sold by June 1, 1991, together with the $50 million of Second Mortgage Bonds to be substituted as collateral under the RCF, will be issued on the basis of retired bonds and property additions under the Second Mortgage Indenture. See discussion below regarding issuance of additional Second Mortgage Bonds.

1992 Financing Requirements. Estimated 1992 capital requirements are $52.1 million for construction expenditures and $61.2 million for long-term debt maturities and preferred stock redemptions. The Company's current 1992 financing plan contemplates long-term financings of $75 million (to be applied to reduce the then outstanding short-term borrowings) and short-term borrowings of $31.9 million. The Company will seek to meet its long-term financing requirements in 1992 through the issuance of additional First Mortgage Bonds and Second Mortgage Bonds. However, assuming that the 1991 long- term financings with First Mortgage Bonds and Second Mortgage Bonds discussed above are closed, the Company will not have any significant financing capacity under its Second Mortgage Indenture, unless the Company were to reduce the committed amount of the RCF, which the Company would not be able to do, and the Company's capacity to finance under the First Mortgage Indenture would be dependent upon the earnings levels that result from the outcome of Docket 9945. See discussion below regarding issuance of additional First Mortgage Bonds and Second Mortgage Bonds.

The Company is exploring alternative sources of long-term debt financings. Such financings could include receivables financing, convertible unsecured debentures, and securitization of contract and other rights to future cash payments, including regulatory deferrals. The Company believes, but there can be no assurance, that the Company will be able to secure alternative sources of long-term financing for 1992, should the Company not have sufficient financing capacity under the First Mortgage Indenture and the Second Mortgage Indenture.

Factors Affecting Ability to Finance. As indicated above, the Company's access to adequate sources of external financing, as well as the magnitude of the Company's ongoing requirements for financing, is dependent upon the ultimate outcome of the Texas rate case in Docket 9945. Although the Company believes that it is entitled to the rate relief sought in Docket 9945, if that Docket does not provide sufficient operating revenues, earnings and cash flows, including a return on and recovery of the Company's plant investment in PVNGS Unit 3, or if the Docket was to result in significant additional regulatory disallowances, which the Company does not expect, the Company's results of operations will be adversely affected and the Company's access to capital markets for the financing that the Company will require will be restricted and, depending on the circumstances, could be eliminated. See "Regulation — Texas Rate Matters — Palo Verde Unit 3".

The credit ratings on the Company's senior securities are below investment grade level. On March 19, 1991, Standard & Poor's Corporation lowered its ratings on the Company's senior securities as follows: First Mortgage Bonds to "BB−" from "BB+", senior unsecured debt and lease obligations to "B" from "BB−", and preferred stock to "CCC" from "BB−". Standard & Poor's indicated that the downgradings reflected the rejection by the City of El Paso of the Company's proposal for the settlement of its Texas jurisdictional revenue requirements, the Company's current financial condition and prospects for financial recovery. In addition, there has been, recently, a general tightening of credit availability in the capital markets, particularly with respect to the placement of non-investment grade long-term debt. The non-investment grade ratings on the Company's senior securities significantly restricts the universe of potential investors. Although the Company believes that, despite the non-investment grade ratings on its senior securities and the general tightening of the credit markets, it will be able to place the long-term financing it requires, such factors could adversely affect the Company's ability to do so, depending upon the outcome of Docket 9945.

The letters of credit supporting the sales and leasebacks by the Company of its interest in Palo Verde Unit 2 expire December 31, 1991, and in the case of one sale/leaseback, January 2, 1992. Such letters of credit must be maintained in effect for the benefit of the related equity investors through at least December 31, 1999, and, in the case of one equity investor, through the basic lease term which expires October 1, 2013. All such letters of credit must be renewed or replaced prior to their expiration in order to avoid default under the related leases, which would entitle the equity investors to draw under the letters of credit. The aggregate amount of such letters of credit is $211.8 million. The renewal or replacement letters of credit must meet certain agreed upon criteria imposed by the equity investors, some of which differ from the terms and conditions of the existing letters of credit. Although the renewal or replacement of the letters of credit will probably require renegotiations with the issuing banks and perhaps the equity investors, the Company believes, but there can be no assurance, that it will be able to renew or replace the letters of credit as required. Failure to renew or replace the letters of credit could adversely affect the Company's access to capital markets for required financing and could, depending upon the circumstances, eliminate that access.

The letters of credit supporting the Company's sales and leasebacks of interests in Palo Verde Unit 3 expire at December 31, 1992. Such letters of credit aggregate $87.5 million and are required to be maintained throughout the basic lease term of the related leases, which expires January 2, 2017. The Company expects that the letter of credit agreements providing for the Unit 3 letters of credit will be renegotiated to the same effect and at the same time as the Unit 2 letters of credit are renegotiated. Such renegotiated terms could, but are not anticipated to, require the consent of the related Unit 3 equity investors.

The Unit 2 and Unit 3 letter of credit agreements and one other bank credit agreement require the Company to meet the same maintenance of equity and fixed charge ratios required to be met under the RCF. The leases and other transaction documents for the Palo Verde Unit 2 sales and leasebacks contain incurrence of debt restrictions which are suspended for so long as complying letters of credit remain in effect. Because the Company expects to be able to maintain complying letters of credit in effect as required under the Unit 2 transaction documents, it does not expect the Unit 2 incurrence of debt restrictions to affect its financing capacity.

Due to the earnings test required to be met under the Company's Restated Articles of Incorporation, losses incurred in 1990 and the outlook of results of operations for 1991 and for a period of time thereafter, the Company anticipates that it will not be able to issue any additional preferred stock in 1991 and for a period of time thereafter without the consent of the holders of a majority of the shares of preferred stock then outstanding.

The Company's Restated Articles of Incorporation provides that, unless consented to by a majority of the shares of preferred stock then outstanding, the aggregate of unsecured long-term debt shall not exceed 10% of the total of the Company's outstanding secured debt, capital and surplus. At December 31, 1990, the Company was permitted to issue approximately $89.6 million in additional unsecured long-term debt.

The Company's First Mortgage Bond Indenture limits the amount of additional First Mortgage Bonds which can be issued. Under the Indenture, the Company may issue additional First Mortgage Bonds (a) to the extent of 60% of the value of unfunded net additions to the Company's utility property, provided net earnings available for interest during a recent twelve-month period were at least twice the annual interest requirements on all bonds to be outstanding and on all prior lien debt and (b) to the extent of the principal amount of retired bonds without, under certain circumstances, being required to meet the earnings test. The Company cannot presently issue additional First Mortgage Bonds on the basis of the net earnings test described in clause (a) and will not be able to issue in 1991 additional First Mortgage Bonds on the basis of such test. The Company's ability to issue in 1992 additional First Mortgage Bonds on the basis of the net earnings test is dependent upon the outcome of the Company's rate case in Docket 9945 as discussed above. The RCF is secured in part by $50 million of First Mortgage Bonds. The RCF provides that, as the Company issues and sells First Mortgage Bonds to meet the long-term financing requirements of the RCF, First Mortgage Bonds held as collateral for the RCF are required to be released to the Company in an amount equal to the proposed financing; subject to the requirement that the RCF must at all times be secured by First and/or Second Mortgage Bonds issued in an aggregate amount equal to the $150 million commitment of the RCF. Such released bonds constitute retired bonds under the Company's First Mortgage Indenture and, therefore, would be available as the basis for the issuance of additional First Mortgage Bonds under the Indenture in an amount equal to the principal amount of the released bonds. See "1991 Long-Term Financing" above.

Under the Company's Second Mortgage Indenture, the Company may issue additional Second Mortgage Bonds (a) on the basis of 40% of the value of unfunded net additions to the utility property and (b) to the extent of the principal amount of retired bonds. At December 31, 1990, unfunded net additions totaled $47.5 million, which was sufficient with the inclusion of $70 million in credits for bonds retired in February 1991, to permit the issuance of approximately $89 million principal amount of new Second Mortgage Bonds.

Short-term borrowings by the Company are limited to amounts approved by the FERC. The Company's current authorization from the FERC for short-term debt, including borrowings under the RCF and the nuclear fuel credit facility, provides for up to $200 million of short-term debt, with maturities no later than December 31, 1991. The Company will file in the near future for an extension of the FERC authorization through December 31, 1993, providing for at least $200 million of short-term borrowings. The Company believes, but has no assurance, that the FERC will grant the requested authorization.

Other Factors Regarding Liquidity and Results of Operations. Other factors which could affect the Company's liquidity condition and results of operations include the matters discussed under the captions "Environmental Matters", "Preferred Stock Tax Indemnity", and "Arizona Tax Matters", in Item 1 of this report, the outcome of the legal proceedings described in Item 3 of this report, and the uncertainty as to the renewal of the Company's franchise with the City of Las Cruces described below under "Results of Operations". With respect to the First Service Life litigation described in Item 3, settlement negotiations are ongoing which would terminate all such litigation as it relates to the Company. The Company is unable to determine whether a settlement will be reached or, if reached, what the terms of the settlement would be.

The credit facility supporting the independent trust established to meet the Company's nuclear fuel requirements provides for short-term borrowing by the Company. To accomplish the borrowings, the trust may borrow under the credit facility available to it to meet the nuclear fuel acquisition requirements, to the extent that such borrowings are not then needed by the trust to meet those requirements, and then loan the funds to the Company. At March 30, 1991, the Company owed the trust under this arrangement approximately $9.8 million. The bank lender to the trust has requested that the Company not borrow any additional funds from the trust and that the Company consider retiring the present outstanding borrowing. If the Company were required to retire the borrowing, the Company's 1991 financing requirements would increase by a corresponding amount. The Company does not intend to attempt additional borrowings from the trust pending the outcome of ongoing discussions with the bank. The bank has given a notice, as permitted under the credit facility, which establishes the termination of the credit facility on January 8, 1993. Absent renegotiation of the facility, the Company will be required to refinance or retire at that time the trust's obligations to the bank. See "Energy Sources — Nuclear Fuel" above.

Dividends. For information regarding dividends on the Company's common stock and preferred stock, and restrictions on the payment of those dividends, see Item 5 of this report.

Results of Operations

The information contained in this section should be read in conjunction with "Liquidity and Capital Resources" discussed above.

The Company's operations have continued to deteriorate in recent years as evidenced by the reported results in the financial statements included in Item 8 of this report. Reported operating results before discontinued operations and preferred stock dividend requirements included a loss of $21.9 million for 1990 and earnings of $2.0 million and $63.9 million in 1989 and 1988, respectively. The key factors contributing to the decline in the Company's operating results are: (1) continued declines in operating income levels; (2) regulatory disallowances, net of tax benefits, of $24.9 million and $16.2 million for 1990 and 1989, respectively; (3) reduction in AFUDC earnings in 1990 resulting from placing in service the Texas jurisdictional portion of Palo Verde Unit 3 and the AIP line in April 1990; and (4) increase in interest costs due to increased borrowings.

The reduction in operating income of $11.7 million and $25.0 million in 1990 and 1989, respectively, results primarily from (1) inadequate rate relief ordered by the Texas Commission effective June 1989 and September 1990 (which include reductions in phase-in deferrals); (2) increased operating and maintenance costs, principally of the Palo Verde Station; and (3) reduced revenues from economy sales resulting from extended outages at Palo Verde during 1989 and through the first half of 1990.

The Company's filing in Docket 9945 seeks a total increase in base revenues of approximately $131.3 million consisting of an approximate $38 million cash increase and an approximate $93.3 million in revenues to be deferred for collection in later years. If that Docket does not provide sufficient operating revenues, earnings and cash flows, including a return on and recovery of the Company's plant investment in PVNGS Unit 3, the Company's results of operations and liquidity will be adversely affected. Hearings on Docket 9945 are scheduled to begin in late April 1991 and a final order from the Texas Commission is expected during the fourth quarter. Although the Company believes that it is entitled to the rate relief sought in Docket 9945, the outcome of the Docket cannot presently be determined. See Item 1, "Regulation — Texas Rate Matters — Palo Verde Unit 3."

The New Mexico portion of the Company's Unit 3 investment, including the Unit 3 lease payments, is deregulated under the New Mexico rate moderation plan. The Company, therefore, is required to recover the investment through off-system sales in the economy energy market. Although the Company believes that over the useful life of Unit 3 the investment will be recovered, market prices for economy energy sales have not been in recent years and are not presently at levels needed by the Company to recover the New Mexico portion of the Company's current operating expenses related to Unit 3, including lease payments. Such market conditions will continue to affect the Company's results of operations. See Item 1, "Regulation — New Mexico Rate Matters."

In July 1989, the City of Las Cruces began a review of possible alternatives to renewal of the Company's franchise and in February 1990 engaged outside consultants to assist in the review. On February 11, 1991, the consultants issued a feasibility report dealing with certain alternatives, including municipalization and acquisition of the Company's distribution system through a negotiated sale or condemnation. The report is under review by both the City of Las Cruces and the Company. The Company believes that the franchise will be renewed, perhaps on renegotiated terms. However, the outcome of the City's review of its alternatives and the ultimate impact on renewal of the franchise cannot be determined at this time. Las Cruces represents approximately 8% of the Company's operating revenues.

The Company and CFE, the national electric utility of Mexico, have substantially negotiated the terms and conditions of an agreement providing for firm power sales of electricity by the Company to CFE for consumption by the City of Juarez, Mexico. Although the Company expects to reach a final agreement with CFE, there can be no assurance that such an agreement will be reached. The agreement would provide for firm sales of capacity and associated energy to CFE over a 5½ year term, commencing on May 1, 1991 and expiring December 31, 1996. The amount of capacity would be initially 40MW, increasing to 120-150 MW no sooner than January 1, 1992, and continuing at that level over the remaining term of the agreement. The increase to 120-150 MW capacity would be dependent upon the completion of construction and upgrading of certain transmission facilities by each party, which are expected to be completed by December 31, 1991. Pricing for the power sales would include an escalating demand charge and full recovery of energy costs and is based on the current market conditions in the southwestern United States. The Company will require certain regulatory approvals for its construction and upgrading requirements, including a permit from the DOE and a CCN from the New Mexico Commission, which approvals the Company expects to be able to obtain. The costs to the Company of construction and upgrading are not expected to exceed $1 million. The Company may be required, and, if required, expects to be able to secure a purchase power agreement, providing for a minimum of 50 MW of capacity to meet the requirements of the agreement with CFE, beginning as early as 1992. The Company has begun preliminary discussions with third parties concerning such a purchase power agreement. Although in the Docket 9945 filing, the Company has requested that it be allowed to retain the full economic benefit of the sales to CFE in order to offset the shortfall arising from deferral of cash rate relief, there can be no assurance as to the ultimate Texas regulatory treatment of the revenues from such sales.

The Company disposed of its non-utility investments and operations in 1989 and 1990. See Note P of Notes to Financial Statements.

The primary reasons for increases (decreases) in results of operations for the year ended December 31, 1990 compared to the year ended December 31, 1989 and the year ended December 31, 1989 compared to the year ended December 31, 1988 are as follows:

Operating Revenues:

The Company continued to experience increases in electric sales and customer growth in its service area during 1990. Native system sales increased from 4,462,183 MWH of electricity in 1989 to 4,541,296 MWH in 1990, an increase of 1.8%. Total system sales increased 1.9% in 1990 compared with 1989. Customers were added to the Company's service area at an annual rate of approximately 2% in

1990. The Company achieved record peak demands in 1990, recording an all-time total system peak load of 1,098 MW on June 27, 1990, which was a 2% increase over 1989's record peak of 1,076 MW. The Company's 1990 native system peak demand of 920 MW, which was also a new record, was a 0.4% increase from the previous record of 916 MW set in 1989. The projected annual native and total system peak load growth rate for the Company's service area during the 1991-2000 time period is approximately 2.5% and approximately 2.2%, respectively.

Base revenues increased for 1990 over 1989 approximately $10,200,000, due primarily to an increase in KWH sales (volume) and an increase in base revenues resulting from rate increases for Texas, effective May 1989 and September 1990, and for New Mexico, effective in May 1990 and from bonded rates for Texas effective June 1990. Base revenues increased for 1989 over 1988 approximately $26,100,000, due primarily to an increase in KWH sales (volume) and an increase in base revenues resulting from rate increases for Texas, which were effective in April 1988 and May 1989, and for New Mexico, effective in November 1988. Base revenues from wholesale customers were $44,110,000, $44,932,000, and $41,327,000 in 1990, 1989 and 1988, respectively.

The reduction in fuel revenues in 1990 and the increase in 1989 is a result of the change in fuel and purchased and interchanged power costs, as discussed under "Operating Expenses."

Operating Expenses:

Other operation and maintenance expenses increased in 1990 primarily due to increased costs at Palo Verde as a result of decreased operating performance during the first half of 1990. It is believed that the necessary actions and adjustments have been and are being taken, and future performance of the Palo Verde units is expected to be at satisfactory levels. This progress is evidenced by the return of Units 1, 2 and 3 to full power. Through December 31, 1990, Palo Verde operated at availability factors above 85% since completing refueling and maintenance outages.

Fuel expenses increased in 1990 compared to 1989 and 1989 compared to 1988 approximately $4,000,000 and $8,400,000, respectively, due to increased KWH sales (volume). Purchased and interchanged power decreased in 1990 compared to 1989 approximately $9,300,000 due to decreased purchases of electricity from others and increased economy sales of electricity to others. Purchased and interchanged power increased in 1989 compared to 1988 approximately $10,400,000 due to increased purchases of electricity from other utilities. The increase in fuel expense and purchased and interchanged power are also a result of the unscheduled outages at Palo Verde. Replacement power used for the loss of Palo Verde capacity results in higher fuel and purchased and interchanged power costs. See Part I, Item 1, "Energy Sources — General."

Other operating and maintenance expense increased in 1989 over 1988 due to the timing of inclusion of the Palo Verde units in rates and increased costs at Palo Verde. The Texas jurisdictional portion of operation and maintenance expense for Palo Verde Units 1 and 2 and two-thirds of common facilities, as well as the book breakeven lease payments for Unit 2, and one-third of common facilities were being deferred until they were included in Texas rates in May 1988. Effective February 1988 through April 1990, the Texas jurisdictional portion of Unit 3 operation and maintenance and lease costs were capitalized into CWIP. Effective May 1990, Palo Verde Unit 3 operating and maintenance expenses are being deferred in the Company's Texas jurisdiction. The effects of the timing of inclusion in rates of these units is reflected in the table below. A decrease in phase-in deferrals from $7.4 million in Docket 8363 to $4.1 million in Docket 9165 in the Company's Texas jurisdiction, and a discontinuance of recording phase-in plan deferrals for the New Mexico jurisdiction is more fully discussed in Part I, Item 1, "Regulation — Texas Rate Matters" and "— New Mexico Rate Matters." Phase-in deferrals in 1989 decreased from 1988 due to a decrease in phase-in deferrals of $25 million in Docket 7460 to $7.4 million in Docket 8363 for the Company's Texas jurisdiction, and a decrease in phase-in deferrals from $3.2 million to $1.2 million in the Company's New Mexico jurisdiction.

	1990	1989	1988
		(In thousands)	
Palo Verde costs	$143,399	$137,453	$121,169
Palo Verde costs deferred(1)(2)	(17,342)	—	(20,511)
Palo Verde costs capitalized	(8,522)	(28,455)	(21,574)
Palo Verde costs expensed	117,535	108,998	79,084
Other non Palo Verde costs	84,918	76,255	73,644
Phase-in plan deferrals	(4,470)	(9,030)	(16,366)
Total operating costs expensed	$197,983	$176,223	$136,362

(1) Under accounting deferral orders.

(2) Does not include other taxes related to Palo Verde of $2,689 and $1,903 in 1990 and 1988, respectively.

Increased Palo Verde costs for the years ending December 31, 1990 and 1989 are net of approximately $1.9 and $4.6 million, respectively, of Texas jurisdictional costs incurred as a result of the Palo Verde outages which have been deferred.

Depreciation and Amortization Expense:

Depreciation expense increased in 1990 over 1989 due to depreciation taken on the AIP transmission line which was placed in service in April 1990. Depreciation expense increased in 1989 over 1988 due to depreciating the Texas jurisdictional portion of Palo Verde Units 1 and 2 and Common Plant beginning with their inclusion in rates in May 1988.

Amortization expense remained constant in 1990 and 1989. Amortization expense increased in 1989 over 1988 due to amortization of Palo Verde deferred costs beginning in May 1988 and November 1988 for Texas and New Mexico, respectively, along with an increased deferred cost balance subject to amortization as of June 1989 for Texas in conjunction with the inclusion of the amortization of such deferred assets as a part of cost of service under the respective rate moderation plans.

Taxes other than Federal Income Taxes:

Taxes other than federal income taxes increased in 1990 as compared to 1989 as a result of Arizona legislation effective December 31, 1989 to levy additional property taxes on utility and mining property. The effect of the enacted legislation was an increase in the Company's Arizona property taxes of $7 million for 1990. Operations reflect a $6 million increase in tax expense (net of $1 million in capitalized and deferred costs for the Texas jurisdiction of Unit 3's property tax increase). The legislation provides for additional increases of $2.4 million in 1991, and a further increase of

$1.7 million in 1992. The cumulative increase results in increased tax expense of $9.4 million in 1991 and $11.1 million in 1992. See "Arizona Tax Matters — Arizona Property Tax," Item 1, Part I. The Company has in its current Texas rate case (Docket 9945 — see "Regulation — Texas Rate Matters — Palo Verde Unit 3" in Item 1, Part I) requested recovery of the new level of taxes in 1991 and 1992.

AFUDC:

AFUDC decreased in 1990 compared to 1989 due to a decreased balance subject to AFUDC resulting from placing in service the Texas jurisdictional portion of Palo Verde Unit 3 and the AIP line in April of 1990. AFUDC increased in 1989 compared to 1988 due to an increase in the cumulative construction balance accruing AFUDC generally associated with Unit 3 in Texas.

Phase-in Plan Deferred Return:

Phase-in plan deferred return decreased in 1990 compared to 1989 due to an overall decrease in the amount of phase-in deferrals allowed by the Texas Commission in Docket 9165 compared to Docket 8363, and inclusion in rate base of the remainder of the Texas Unit 1 and 2 deferred operation and maintenance costs in Docket 8363 (effective June 1989), and a change in the methodology of calculating the return on the overall balance of phase-in deferrals. This decrease is offset by an overall increase in the balance of phase-in deferrals accruing a return. Phase-in plan deferred return decreased in 1989 compared to 1988 due to an overall decrease in the amount of phase-in deferrals allowed by the Texas Commission in Docket 8363 compared to Docket 7460; offset by an overall increase in the balance of phase-in plan deferrals accruing a return.

Regulatory Disallowance:

Regulatory disallowance for 1990 represents write offs in connection with the Texas fuel reconciliation case, which represents: fuel cost adjustments through March 1989, related adjustments through July 1990, interest on the refund and unamortized costs related to a nuclear fuel joint venture; Texas Docket 9165 write-offs of corporate restructuring costs, rate case expenses, and deferred tax benefits; and, previously recorded New Mexico phase-in deferrals as of June 30, 1990 due to the inability of the Company to amend its New Mexico rate moderation plan to be in conformity with SFAS No. 92.

Regulatory disallowance for 1989 represents write-offs in connection with Texas Docket 8363 related to previously deferred operation and maintenance costs for Palo Verde Units 1 and 2.

Investment Income:

Investment income increased in 1990 compared to 1989 due to the effect of recording an unrealized loss on the Company's investment in annuities recorded in 1989 with no comparable amount in 1990 partially offset by decreased average investment balances and decreased average investment return. Investment income decreased in 1989 compared to 1988 due to unrealized losses on the Company's investment in annuities and decreased average investment balances (See Part I, Item 3, "First Service Life Litigation").

Other Income, Net:

Other income, net, increased in 1990 compared to 1989 as a result of an adjustment recorded in 1990 with no comparable amount in 1989 which decreased the provision for an expected performance penalty incurred by the Company under the Palo Verde performance standards in its New Mexico jurisdiction. Other income, net, decreased in 1989 compared to 1988 as a result of recording a provision for an expected performance penalty incurred by the Company under the Palo Verde performance standards in its New Mexico jurisdiction.

Interest on Long-Term and Financing and Capital Lease Obligations:

Interest on long-term and financing and capital lease obligations increased in 1990 over 1989 due principally to the issuance in January 1990 of the 11.1% Series First Mortgage Bonds. The increase was partially offset by a decrease in interest expense due to the redemption in November 1989 of the 14% Series First Mortgage Bonds, the redemption in August 1989 of the 14½% Series First Mortgage Bonds and the redemption in May 1989 of the 12¾% Series First Mortgage Bonds. Interest on long-term and financing and capital lease obligations decreased in 1989 over 1988 due principally to the redemption in May 1989 of the 12¾% Series First Mortgage Bonds, the redemption in July 1989 of the 14½% Series First Mortgage Bonds, the redemption in November 1989 of the 14% Series First Mortgage Bonds and decreased interest on the nuclear fuel lease obligation.

Other Interest Expense:

Other interest expense decreased in 1990 over 1989 due to a decrease in the average short-term debt rate and was partially offset by an increase in the average short-term debt outstanding. Other interest expense increased in 1989 over 1988 due to an increase in the average short-term debt outstanding and the average short-term debt rate.

Interest Capitalized and Deferred:

Interest capitalized increased in 1990 over 1989 due to interest capitalized on the Texas portion of Unit 3, and its related deferred operation and maintenance expenses beginning in May 1990. Interest capitalized decreased in 1989 from 1988 due to the interest capitalized on the Texas portion of Unit 1 and the deferred operation and maintenance expenses associated with Unit 1 and 2 during 1988 with no comparable interest capitalized in 1989 and decreased interest capitalized related to nuclear fuel lease obligation due to a decreased average nuclear fuel balance.

Preferred Stock Dividend Requirements:

Preferred stock dividend requirements increased in 1990 compared to 1989 due to a settlement of a claim by the $11.375 preferred stockholders pursuant to a tax indemnity agreement. The claim arose from the reduction in the dividends received deduction due to the enactment of the Tax Reform Act of 1986 and the Revenue Act of 1987. The increase was partially offset by scheduled redemptions.

Preferred stock dividend requirements decreased in 1989 over 1988 due to scheduled redemptions.

Effects of Inflation:

In contrast to the analysis of increases in base revenues included at the beginning of "Results of Operations," it is sometimes difficult, in the case of operation and maintenance expenses, to distinguish between effects of volume increases and rises in unit costs (which, for purposes of this discussion, are all attributed to inflationary pressures).

Price changes in fuel costs are passed through to certain FERC customers pursuant to fuel cost adjustment provisions. Fuel price changes in the Company's Texas and New Mexico jurisdictions and two FERC customers require fuel reconciliation hearings for the over or under recovery of fuel costs. There are a number of other major expense items such as maintenance costs, payroll costs and other operating costs that are beyond the scope of the fuel reconciliation hearings and the fuel cost adjustment provisions. Inflationary pressures on these items have given rise to earnings attrition between general rate increases. See "Regulation" in Part I, Item 1.

Environmental Matters:

For a discussion of environmental matters, see Item 1, "Environmental Matters."

Effect of Recently Issued Accounting Standards:

See Note A of Notes to Financial Statements regarding the effect of SFAS No. 96, *Accounting for Income Taxes*, and SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.*

Item 8. Financial Statements and Supplementary Data

INDEX TO FINANCIAL STATEMENTS

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INDEPENDENT AUDITORS' REPORT

The Shareholders and Board of Directors
El Paso Electric Company:

We have audited the accompanying balance sheets of El Paso Electric Company as of December 31, 1990 and 1989, and the related statements of income (loss), retained earnings and cash flows for each of the years in the three-year period ended December 31, 1990. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of El Paso Electric Company as of December 31, 1990 and 1989, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 1990 in conformity with generally accepted accounting principles.

As discussed in Note L of Notes to Financial Statements, the Company is a defendant in three lawsuits and, pursuant to indemnity provisions, is contingently liable with respect to a lawsuit in which a former executive officer of the Company is one of the defendants. The ultimate outcome of such litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication of any of the lawsuits has been made in the accompanying financial statements.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note C of Notes to Financial Statements, the Company is dependent upon access to adequate sources of external debt financing for its liquidity. As discussed in Note B of Notes to Financial Statements, the Company has filed a rate case with the Texas Commission (Docket 9945) which requests an increase in base revenues of $131.3 million to be phased-in pursuant to a qualified phase-in plan. The rate case, among other things, requests inclusion in Texas jurisdictional rate base of the Company's plant investment in PVNGS Unit 3. If the outcome of Docket 9945, which cannot presently be determined, fails to provide sufficient operating revenues, earnings and cash flows, including a return on and recovery of the plant investment in PVNGS Unit 3, the Company's access to capital markets for the financing that the Company requires will be restricted and, depending on the circumstances, could be eliminated. Until this uncertainty is resolved, substantial doubt exists about the Company's ability to continue as a going concern. The financial statements do not include any adjustments, including any loss from a regulatory disallowance related to the PVNGS Unit 3 plant investment, that might result from the outcome of this uncertainty.

KPMG PEAT MARWICK

El Paso, Texas
March 29, 1991

EL PASO ELECTRIC COMPANY

BALANCE SHEETS

ASSETS

	December 31, 1990	December 31, 1989
	(In thousands)	
Utility plant (Notes B, D and E):		
Electric plant in service	$1,555,505	$1,203,801
Less accumulated depreciation and amortization	266,384	233,387
Net plant in service	1,289,121	970,414
Construction work in progress	56,601	344,768
Nuclear fuel under capital leases net of amortization of $65,672,000 and $73,920,000, respectively	51,424	47,114
Net utility plant	1,397,146	1,362,296
Current assets:		
Cash and temporary investments	12,115	28,370
Accounts receivable, principally trade, net	44,343	44,251
Inventories	35,167	33,678
Federal income taxes refundable (Note K)	10,860	29,328
Net undercollection of fuel revenues (Note B)	9,733	10,127
Prepayments and other	19,979	18,638
Total current assets	132,197	164,392
Long-term contract receivable (Note B)	22,290	16,482
Deferred charges and other assets:		
Palo Verde deferred costs (Note B)	128,455	95,533
Phase-in plan deferrals (Note B)	42,794	52,759
Other (Note G)	85,763	78,056
Total deferred charges and other assets	257,012	226,348
Total assets	$1,808,645	$1,769,518

See accompanying notes to financial statements.

EL PASO ELECTRIC COMPANY

BALANCE SHEETS

CAPITALIZATION AND LIABILITIES

	December 31, 1990	December 31, 1989
	(In thousands)	
Capitalization (Notes E, H, I and J):		
Common stock, no par value, 100,000,000 and 40,000,000 shares authorized, respectively. Issued and outstanding 35,352,211 and 35,201,267 shares, respectively	$ 338,302	$ 337,176
Retained earnings	33,388	67,133
Common stock equity	371,690	404,309
Preferred stock, cumulative, no par value, 2,000,000 shares authorized:		
Redemption required	79,360	100,710
Redemption not required	14,198	14,198
Long-term obligations	653,592	590,686
Financing and capital lease obligations	119,925	119,392
Total capitalization	1,238,765	1,229,295
Current liabilities:		
Current maturities of long-term and financing and capital lease obligations (Note J)	115,590	49,100
Notes payable and revolving credit facility (Note C)	14,756	46,756
Accounts payable, principally trade	14,701	21,583
Taxes accrued other than FIT	22,720	19,411
Interest accrued	15,480	15,758
Refund of fuel revenues, including interest	10,580	—
Other	44,019	43,761
Total current liabilities	237,846	196,369
Deferred credits and other liabilities:		
Accumulated deferred income taxes (Note K)	66,847	59,983
Accumulated deferred investment tax credit (Note K)	81,220	96,352
Deferred gain on sales and leasebacks (Note E)	168,461	175,633
Other	15,506	11,886
Total deferred credits and other liabilities	332,034	343,854
Commitments and contingencies (Notes B, D, E, L and M)		
Total capitalization and liabilities	$1,808,645	$1,769,518

See accompanying notes to financial statements.

EL PASO ELECTRIC COMPANY

STATEMENTS OF INCOME (LOSS)

For the years ended December 31, 1990, 1989 and 1988
(In thousands except per share data)

	1990	1989	1988
Operating revenues	$432,501	$ 426,248	$382,107
Operating expenses:			
Operations:			
Fuel	84,599	80,607	72,187
Purchased and interchanged power	24,997	34,261	23,917
	109,596	114,868	96,104
Other	188,959	159,635	148,749
Maintenance	30,836	25,618	24,490
Depreciation and amortization	44,188	41,949	34,254
Palo Verde deferred costs (Note B)	(20,031)	—	(22,414)
Phase-in plan deferrals (Note B)	(4,470)	(9,030)	(16,366)
Taxes:			
Federal income taxes (benefit) (Note K)	(5,533)	1,531	8,648
Other	44,157	35,126	27,109
	387,702	369,697	300,574
Operating income	44,799	56,551	81,533
Other income (deductions):			
Allowance for equity funds used during construction	4,853	12,578	13,065
Phase-in plan deferred return (Note B)	2,825	10,513	12,603
Regulatory disallowance (Note B)	(37,378)	(22,229)	—
Investment income (Note F)	2,534	1,093	20,555
Other, net	634	(8,034)	(2,630)
Federal income taxes applicable to other income (Note K):			
Regulatory disallowance	12,456	6,051	—
Other	(2,845)	(4,054)	(9,313)
	(16,921)	(4,082)	34,280
Income before interest charges	27,878	52,469	115,813
Interest charges (credits):			
Interest on long-term and financing and capital lease obligations	71,032	63,025	69,199
Other interest	10,582	11,010	4,454
Palo Verde deferred costs — carrying charges	(15,244)	—	(5,012)
Other interest capitalized and deferred	(7,308)	(6,203)	(8,292)
Allowance for borrowed funds used during construction	(9,320)	(17,319)	(8,413)
	49,742	50,513	51,936
Income (loss) from continuing operations	(21,864)	1,956	63,877
Discontinued operations (Note P):			
Loss from discontinued operations, net of income tax credits of $1,731 and $6,490, respectively	—	(8,184)	(3,554)
Provision for loss on disposal of operations, including provision of $7,669 and $11,520 for operating losses during phase-out periods, net of income tax credits of $28,210 and $18,522, respectively	—	(99,605)	(35,954)
	—	(107,789)	(39,508)
Net income (loss)	(21,864)	(105,833)	24,369
Preferred stock dividend requirements	11,881	11,812	12,259
Net income (loss) applicable to common stock	$(33,745)	$(117,645)	$ 12,110
Net income (loss) per weighted average shares of common stock:			
Income (loss) from continuing operations	(0.96)	(0.28)	1.48
Discontinued operations	—	(3.07)	(1.13)
Total	$ (0.96)	$ (3.35)	$ 0.35

See accompanying notes to financial statements.

EL PASO ELECTRIC COMPANY

STATEMENTS OF RETAINED EARNINGS

For the years ended December 31, 1990, 1989 and 1988
(In thousands except per share data)

	1990	1989	1988
Retained earnings at beginning of year	$ 67,133	$ 198,131	$239,320
Add:			
Net income (loss)	(21,864)	(105,833)	24,369
	45,269	92,298	263,689
Deduct:			
Cash dividends:			
Preferred stock	11,881	11,812	12,259
Common stock	—	13,353	53,254
Capital stock expense	—	—	45
	11,881	25,165	65,558
Retained earnings at end of year	$ 33,388	$ 67,133	$198,131
Dividends declared per share of common stock	$ —	$ 0.38	$ 1.52
Weighted average number of common shares outstanding	35,315,542	35,165,514	35,029,975

See accompanying notes to financial statements.

EL PASO ELECTRIC COMPANY

STATEMENTS OF CASH FLOWS

For the years ended December 31, 1990, 1989 and 1988

	1990	1989	1988
		(In thousands)	
Cash Flows From Operating Activities:			
Income (loss) from continuing operations	$(21,864)	$ 1,956	$ 63,877
Adjustments for non-cash items from operating activities:			
Depreciation and amortization	31,628	28,381	24,191
Amortization of nuclear fuel	34,416	12,156	22,527
Deferred income taxes and investment tax credit, net	(15,951)	16,341	14,610
Allowance for equity funds used during construction	(4,853)	(12,578)	(13,065)
Regulatory disallowance	37,378	22,229	—
Other operating activities	11,970	8,653	(5,648)
Discontinued operations, net	—	(919)	(3,554)
Accounts receivable	(92)	945	(7,895)
Inventories	(4,293)	(1,745)	(610)
Federal income taxes refundable	24,602	(29,328)	—
Net undercollection of fuel revenues	(13,145)	(10,127)	—
Long-term contract receivable	(5,808)	(7,340)	(7,632)
Net assets of discontinued operations	—	(5,860)	6,074
Accounts payable	(6,882)	7,720	(2,465)
Taxes accrued	3,309	11,401	(16,812)
Refund of fuel reserves, including interest	10,580	—	—
Other	(13,865)	3,979	(8,706)
Other deferrals	(2,578)	(12,726)	(12,719)
Palo Verde deferred costs	(35,162)	1,902	(24,626)
Phase-in plan deferrals	(7,187)	(19,145)	(29,348)
Net cash provided by (used for) operating activities	22,203	15,895	(1,801)
Cash Flows From Investing Activities:			
Additions to utility plant	(73,676)	(138,222)	(92,910)
Allowance for equity funds used during construction	4,853	12,578	13,065
Additions to non-utility property	—	(966)	(14,738)
Other investing activities	702	1,213	3,021
Net cash provided by (used for) investing activities	(68,121)	(125,397)	(91,562)
Cash Flows From Financing Activities:			
Proceeds from long-term obligations	145,659	168,358	16,567
Redemption of securities	(21,350)	(7,750)	(2,150)
Dividends paid	(11,881)	(25,165)	(65,513)
Redemption of long-term obligations	(51,891)	(122,007)	(153,527)
Net increase (decrease) in short-term obligations	(32,000)	22,000	(104,229)
Other financing activities	1,126	1,409	(859)
Net cash provided by (used for) financing activities	29,663	36,845	(309,711)
Net increase (decrease) in cash and temporary investments	(16,255)	(72,657)	(403,074)
Cash and temporary investments at beginning of year	28,370	101,027	504,101
Cash and temporary investments at end of year	$ 12,115	$ 28,370	$ 101,027
Supplemental Disclosures of Cash Flow Information:			
Cash paid during the year for:			
Income taxes	$ —	$ 387	$ 19,427
Interest on borrowed money from continuing operations	69,286	62,273	63,678
Non-cash transactions:			
Capitalization of nuclear fuel and related obligation	36,317	—	20,084

For the purposes of this statement, all temporary cash investments with a maturity of three months or less are considered cash equivalents.

See accompanying notes to financial statements.

EL PASO ELECTRIC COMPANY

NOTES TO FINANCIAL STATEMENTS

A. Summary of Significant Accounting Policies

General

El Paso Electric Company maintains its accounts in accordance with the Uniform System of Accounts prescribed for electric utilities by the FERC. The Company reports its regulated utility operations pursuant to SFAS No. 71 — *Accounting for the Effects of Certain Types of Regulations*, as amended.

Utility Plant

Utility plant is stated at original cost and depreciation is provided on a straight-line basis at annual rates which will amortize the undepreciated cost of depreciable property over the estimated remaining service lives. The average annual depreciation rate used by the Company for utility plant other than the Palo Verde Station was 2.90% in 1990, 3.17% in 1989, and 3.43% in 1988. The average annual depreciation rate for the portions of the Palo Verde Station for which the Company is providing depreciation was 2.50% for New Mexico and FERC jurisdictions in 1990, 1989 and 1988 and 2.64% in 1990 and 2.62% in 1989 and 1988 for the Texas jurisdictional portion which began in April 1988.

The Company charges the cost of repairs and minor replacements to the appropriate operating expense accounts and capitalizes the cost of renewals and betterments. The cost of depreciable utility plant retired or sold and the cost of removal, less salvage, are charged to accumulated depreciation.

The Company is amortizing nuclear fuel under capital leases pursuant to the units of heat production method.

Decommissioning cost for the Company's interest in the PVNGS is charged to depreciation expense. Additionally, the Company is depositing decommissioning costs currently being recovered in rates in external trust funds until the decommissioning of the facility takes place.

AFUDC

The Company's applicable regulatory bodies, FERC, the New Mexico Commission and the Texas Commission, generally provide for the capitalizing of AFUDC, which is defined as an amount which includes the net cost during a period of construction of borrowed funds used for construction purposes plus a reasonable rate on other funds when so used. While AFUDC results in an increase in the cost of utility plant under construction, with a corresponding increase in income, it is not current cash income. AFUDC, net of certain tax effects, is normally recovered in cash over the service life of utility plant in the form of increased revenue collected as a result of higher depreciation expense. The Company records AFUDC during the construction period of utility plant.

The amount of AFUDC is determined by applying an accrual rate to the balance of certain CWIP costs. In this connection, the FERC has promulgated procedures for the computation (a prescribed formula) of the accrual rate. The weighted average accrual rate was 10.5% for 1990 and 1989 and 11.1% for 1988. The Company compounds AFUDC on major construction projects semiannually. Prior to May 1988, certain amounts of CWIP had been allowed in the Company's rate base or had been made the basis of extraordinary cash rate relief, and appropriate amounts were credited to the CWIP balance based on the application of the AFUDC accrual rate to the amounts of CWIP included in rate base.

Operating Revenues

Operating revenues are accrued with respect to sales of electricity for services provided subsequent to monthly billing cycle dates but prior to the end of the accounting period.

Fuel Cost Adjustment Provisions

The Company's Texas and New Mexico retail customers are presently being billed under fixed fuel factors approved by the Texas Commission and the New Mexico Commission. The Company's Texas and New Mexico fuel factors are set in the Company's general rate case or Commission ordered fuel reconciliation. In the Texas jurisdiction and New Mexico jurisdiction, the Company's fixed fuel factor is subject to adjustment if the utility materially over-or under-recovers its allowable fuel costs under its existing fuel factor. (See Note B).

Rate tariffs currently applicable to certain FERC jurisdictional customers contain appropriate fuel and purchased power cost adjustment provisions designed to recover the Company's fuel and purchased power costs. Two FERC customers have fixed fuel factors approved under FERC tariffs for which no fuel reconciliation is made.

Federal Income Taxes and Investment Tax Credits

Deferred income taxes are provided as a result of timing differences in reporting income and expense items for financial statement and income tax purposes.

With respect to investment tax credit generated by the Company, such investment tax credit utilized is deferred and amortized to income, once such related properties are considered "operational" by the Company's regulatory authorities, over the estimated average remaining useful lives of the Company's fixed assets directly or indirectly involved in the generation and transmission of electricity.

SFAS No. 96, *Accounting for Income Taxes*, was issued by the Financial Accounting Standards Board in December 1987. SFAS No. 96 requires a change from the deferred method to the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred income taxes are recognized for the tax consequences of "temporary differences" by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. SFAS No. 96, as amended, is effective for fiscal years beginning after December 15, 1991.

The Company estimates that adoption of SFAS No. 96 will result in a reduction in the balance of accumulated deferred income tax liability and the creation of a liability to the Company's ratepayers for the effect on regulated assets and liabilities of the reduction of the federal statutory income tax rate from 46% to 34% as provided for by the Tax Reform Act of 1986. This reduction in accumulated deferred income taxes will be partially offset by the effect of new temporary differences resulting from SFAS No. 96, such as allowance for equity funds used during construction and accumulated deferred investment tax credits. The portion of the regulated liability created by SFAS No. 96 relating to certain temporary differences (i.e. accelerated depreciation) will be recorded as long-term and be amortized over the remaining life of the assets giving rise to the temporary difference. With respect to its nonregulated assets and liabilities, the Company estimates the adoption of SFAS No. 96 will cause a writedown of the deferred tax assets that results from the reduction in the statutory tax rate from 46% to 34%. Such adjustment is presently estimated to be approximately $12 million.

The Company may recognize the cumulative effect of a change in accounting principle upon adoption of SFAS No. 96 or restate prior period financial statements to conform to the provisions of the statement. The Company has not decided when it will implement SFAS No. 96 and has not decided upon the method of adoption.

Postretirement Benefits Other Than Pensions

The Company provides benefits other than pensions to its employees upon their retirement. These benefits, some of which require retiree contributions toward the cost, continue for the lifetime of the retirees and their eligible dependents.

SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, was issued by the Financial Accounting Standards Board in December 1990. SFAS No. 106 requires a change from the pay-as-you-go accounting method for these postretirement benefits to the accrual accounting method. The effective date of SFAS No. 106 is for fiscal years beginning after December 15, 1992.

The accrual accounting method recognizes the costs of postretirement benefits other than pensions over the years of service of employees, rather than when the benefits are paid out after the employee retires. With respect to the obligation for benefits already earned as of the date of its adoption (called the "transition obligation"), SFAS No. 106 provides for either amortizing the transition obligation amount over future years or expensing it in the period of adoption.

The accrual expense is expected to exceed the pay-as-you-go expense during the years immediately following adoption of the standard. However, the magnitude of the financial impact on the Company's statements at the time of adoption is not known at this time.

The Company expects that the increased benefits expense will either be recovered currently through rates or that a regulatory asset will be recorded to reflect amounts to be recovered through rates in the future as the costs are paid; therefore, SFAS No. 106 should not have a significant impact on the Company's financial position or results of operations.

Reclassification

Certain amounts in the financial statements for 1989 and 1988 have been reclassified to conform with the 1990 presentation.

B. Rate Matters

Texas. The rates and services of the Company in Texas municipalities are regulated by those municipalities and in unincorporated areas by the Texas Commission. The Texas Commission has exclusive de novo appellate jurisdiction to review municipal orders and ordinances regarding rates and services, and its decisions are subject to judicial review.

New Mexico. The New Mexico Commission has authority over the Company's rates and services in New Mexico, the issuance of securities by the Company and other matters affecting the operations of the Company.

FERC. The Company is subject to regulation by the FERC in certain matters, including rates for wholesale power sales and the issuance of securities. In addition, Congress has enacted energy legislation which, among other things, establishes national standards for consideration by state regulatory agencies in determining utility rates and imposes other requirements on the operations of utilities, including the Company. Under certain circumstances, the FERC may order interconnection, wheeling and pooling.

NRC. The Palo Verde Station is subject to the jurisdiction of the NRC, which has authority to issue permits and licenses and to regulate nuclear facilities in order to protect the health and safety of the public from radiation hazards and to conduct environmental reviews pursuant to the National Environmental Policy Act. Before any nuclear power plant can become operational, an operating license from the NRC is required. The NRC has granted facility operating licenses for Unit 1, Unit 2 and Unit 3 for terms of forty years each beginning December 31, 1984, December 9, 1985 and March 25, 1987, respectively.

Texas Rate Matters

Rate Moderation Plan — Palo Verde Units 1 and 2. On March 30, 1988, in Docket 7460, the Texas Commission adopted a rate moderation plan which provides for the inclusion in Texas rates, on a phase-in basis, of the Texas jurisdictional portion of the Company's investment in Palo Verde Unit 1, Common Plant and the Company's lease payments on its sales and leasebacks of its interest in Palo Verde Unit 2 (including one-third of such Common Plant) to the extent of the book value of the plant sold and leased back (which is approximately 83% of such lease payments).

The Texas Commission's order was based upon a stipulation entered in October 1987 between the Company, the staff of the Texas Commission and certain industrial customers. Three parties who did not join in the stipulation, the City of El Paso and two other intervenors representing public entities, opposed the adoption of the stipulation as the basis of the Commission order and appealed the order to state district court in Travis County, Texas. The district court upheld the order of the Texas Commission, and its decision was appealed by the same parties to the Court of Appeals for the 3rd Judicial District at Austin, Texas. After briefing and oral arguments by the parties on the merits, the appellate court requested briefs from the parties concerning whether the Texas Commission's order is a final order under its terms. The Court raised the issue on its own motion, and all parties to the appeal submitted briefs supporting the finality of the order. If the appellate court were to find that the order was not a final order, the case would be remanded to the Texas Commission, which could reconsider the case in its entirety. If the case were to be remanded to the Texas Commission, the most likely outcome, in the Company's opinion, is that the Texas Commission would take such action as would be necessary under the Court's ruling to make the order final without impacting the matters ordered by the Texas Commission in the present order. A ruling on the appeal is expected in the spring of 1991. Although the outcome of the appeal cannot presently be determined, the Company believes that the appellate court will rule that the Texas Commission's order is a final order and that the Texas Commission's order will be upheld on appeal.

The stipulation and the Texas Commission's final order settled all issues regarding prudence of construction of Palo Verde Units 1 and 2 and Common Facilities and all issues involving the prudence of the Company's decisions to make the investment in the Palo Verde Project and to continue that investment, except, as to Unit 3 only, decision making relating to events occurring after the 1978 issuance by the Texas Commission of a CCN for the Palo Verde Project. See discussion below regarding the Unit 3 rate case. The stipulation also settled all issues of excess capacity relating to Units 1 and 2 for the duration of the ten-year rate moderation plan, and the Texas Commission has indicated that it will not consider excess capacity issues relating to Units 1 and 2 during such time period.

The Texas Commission's order in Docket 7460 limits the Company to specified base rate (cash) increases during the first four years of the plan. The plan requires that the Company file rate cases annually to establish the Company's revenue requirements and resulting right to the base rate increases. To the extent the Company's base revenue requirements recognized by the Texas Commission exceed the base rate increase provided for the period, the unrecovered revenue requirements are deferred for collection in later years of the plan. The plan, which is explicitly intended to comply with SFAS No. 92, *Regulated Enterprises — Accounting for Phase-In Plans,* requires all revenue deferrals to be recovered within the ten-year term of the plan. The Company is, under the plan, entitled to additional base rate increases for years subsequent to the scheduled fourth increase, if necessary, to recover all such deferrals during such time period. The Company has, in its current filing in Docket 9945 (described below) indicated the need for additional base rate increases under the Docket 7460 plan of at least 3.5% in each of the six remaining years of the plan. See "Palo Verde Unit 3" below.

The Texas Commission has entered final orders providing for the first three scheduled base rate increases under the Docket 7460 plan. The first increase of approximately $21 million, together with deferral of approximately $25 million, was ordered in Docket 7460. In May 1989, the Texas Commission entered its final order in Docket 8363, which granted the scheduled second increase in base rates of approximately $7.3 million and ordered deferral of approximately $7.4 million. The Company had requested in Docket 8363 an increase in base revenues of approximately $39 million. The Texas Commission's order in Docket 8363 was appealed by the Company and other parties to the case to state district court in Travis County, Texas, where the appeal remains pending. A decision on the appeal is not expected before the end of this year. The outcome of the appeal cannot presently be determined.

In August 1990, the Texas Commission entered its final order in Docket 9165, which granted the scheduled third base rate increase of approximately $7.1 million and ordered deferral of approximately $4.1 million. The Company had requested an increase in base revenues of approximately $33.9 million. Rates based upon the final order in Docket 9165 became effective in September 1990. In connection with the final order, the Company wrote off approximately $4 million of corporate restructuring costs, rate case expenses, and deferred tax benefits. The Company and the City of El Paso have appealed the Texas Commission's order in Docket 9165 to state district court in Travis County, Texas, where the appeal remains pending. No decision on the appeal is expected before the end of this year, and the outcome of the appeal cannot presently be determined.

On December 28, 1990, the Company filed for the scheduled fourth increase in base rates under the terms of the Docket 7460 plan and for the recovery of the Texas portion of the Company's investment in, and lease payments on, Palo Verde Unit 3. For a description of the filing, see "Palo Verde Unit 3" below.

Palo Verde Unit 3. Palo Verde Unit 3 began commercial operation in January 1988. The unit did not, however, satisfy Texas Commission criteria for in-service status, and consequent eligibility for inclusion in Texas rates, until the AIP transmission facilities were energized in April 1990. Construction of the AIP transmission facilities was completed in December 1989 and the line was energized as part of an arbitration agreement entered into by the Company and PNM, under which the parties agreed to submit to binding arbitration the entitlement of the parties to transmission rights and capabilities involving the SNMTS, to which the AIP transmission facilities are interconnected. The Texas Commission has ruled that Unit 3 met the Texas criteria for in-service status for ratemaking purposes as of May 4, 1990.

In September 1989, the Company filed an application with the Texas Commission for an accounting order to allow the Company to defer substantially all Unit 3 operating costs (excluding fuel) and to accrue a carrying charge on its ownership interest in Unit 3, from the date Unit 3 satisfied the Texas in-service criteria until the Texas Commission issues its rate order addressing the Company's investment in Unit 3. Operating and maintenance expenses associated with the AIP transmission line were not included in the Company's request for the deferral order. On August 29, 1990, the Texas Commission approved the Company's application for the accounting order. From May 4, 1990, through the end of 1990, the Company deferred approximately $31.9 million of Unit 3 costs pursuant to this accounting order. The Company has requested in its Docket 9945 filing that all Unit 3 costs deferred through the effective date of the rate order addressing the Company's investment in Unit 3 be recovered over the remaining life of the asset. The Company believes, based upon past practice of the Texas Commission with regard to inclusion in rates of amounts deferred pursuant to approved accounting deferral orders, that such amounts will be recovered.

On December 28, 1990, the Company filed with the Texas Commission (Docket 9945) a combined request for the scheduled fourth base rate increase under the Docket 7460 rate moderation plan on Units 1 and 2, including the Company's investment in AIP, and the recovery of the Texas jurisdictional portion of the Company's investment in Palo Verde Unit 3 and the lease payments, net of deferred gain, on the Company's sales and leasebacks of a 40% interest in Unit 3. The filing requests a rate moderation plan incorporating three increases, with respect to the Company's interest in Unit 3, designed to comply with SFAS No. 92, *Regulated Enterprises — Accounting for Phase-In Plans.* The Unit 3 plan would continue through 1999. The Company, under its filing, would be entitled to additional base rate increases for years subsequent to the scheduled third increase, if necessary, to recover all deferrals during the term of the Unit 3 plan.

The Company's filing in Docket 9945 seeks a total increase in base revenues of approximately $131.3 million (approximately $82.3 million for Unit 3 and approximately $49 million for Units 1 and 2), consisting of an approximate $38 million cash increase, which includes approximately $7.6 million for the scheduled fourth base rate increase under the Docket 7460 plan for Units 1 and 2, and approximately $30.4 million for the scheduled first base rate increase on Unit 3, and approximately $93.3 million in revenues to be deferred, with a return thereon, for collection in later years. The requested base rate increase, net of approximately $3.8 million of fuel savings, is approximately $34.2 million (a 12.1% increase in total Texas revenues).

Issues relating to the prudence of construction costs directly attributable to Unit 3 and issues relating to the prudence of the Company's decisions to continue the level of its Unit 3 investment, insofar as those issues relate to events occurring after 1978 were not resolved by the Docket 7460 decision involving Units 1 and 2 and are therefore open for decision in the Unit 3 case. However, the Company believes the construction costs of Palo Verde were prudent and reasonable and that its decisions to continue the level of its investment in Unit 3 after the 1978 issuance by the Texas Commission of the CCN were prudent. The Company, therefore, does not expect any material disallowance of Unit 3 costs on the basis of construction imprudence or decisional imprudence. The Company believes that, among other reasons, the outcome of the prudence audit ordered by the Arizona Corporation Commission demonstrates that the construction costs of Palo Verde were prudent and reasonable. The report on the prudence audit, released by Ernst & Whinney on March 24, 1989, identified approximately $60 million of costs, excluding AFUDC and property taxes, for the entire Palo Verde project that were unreasonable; neither the Company nor APS accepts such finding. Of the $60 million, the Company's share would be approximately $9.5 million. The report also identified certain areas that were found to exceed the standard of reasonableness and to have a positive impact on the Palo Verde Project, including built-in separation of electrical equipment, design replication of the three Palo Verde Units, certain aspects of the regulatory (licensing) management function, and certain labor and contractual arrangements. The report estimated that the potential direct cost savings of the identified areas in which performance exceeded the standard of reasonableness were approximately $300 million for the entire project (excluding AFUDC and property taxes), of which the Company's share would be approximately $47.4 million.

The Company expects that parties to Docket 9945 adverse to the Company will assert that Unit 3 represents "excess capacity." The Company continues to believe that Unit 3 is not "excess capacity" and will strenuously defend that position and will continue to seek the full recovery of Unit 3 costs and the inclusion of the unit in rate base. If any excess generating capacity were to be found by the Texas Commission relating to Unit 3, the Company believes the amount of any resulting exclusion from rate base would probably be temporary and would be restored to rate base in future rate proceedings to permit full recovery of substantially all of the Texas jurisdictional portion of the Company's investment in Unit 3. If the Company were denied adequate and timely rate relief sufficient to recover the investment and a fair return thereon, the Company would resort to the courts for the rate relief to which it believes it is entitled. Although the Company does not believe it is probable that significant additional write-offs from regulatory disallowances will occur as a result of the outcome of Docket 9945, the ultimate outcome of the case cannot presently be determined.

Failure to receive sufficient inclusion in Texas rates of the Company's Unit 3 investment, on a timely basis, would increase the Company's external financing requirements and could adversely affect access to the capital markets. An adverse regulatory decision by the Texas Commission with respect to the Company's investment in Unit 3 which, in the judgment of the lending banks under the RCF, causes the Company's revenues to be insufficient to assure its ongoing viability or its access to capital markets or its ability to repay its obligations, constitutes an event of default under the RCF. See Note C.

Hearings on Docket 9945 before the Texas Commission are scheduled to begin in late April 1991, and a final order from the Texas Commission is expected during the fourth quarter of 1991. The Company may seek to place a portion of its requested cash rate relief into effect under bond, subject to refund, as of mid summer; bonding would, absent a refund, reduce the amount of deferred costs recorded.

On March 12, 1991, the Company made a proposal to the City of El Paso for the settlement of its Texas jurisdictional revenue requirement over the next ten years. The Company's proposal included a ten-year plan for the inclusion of Unit 3 in Texas rates along with previously allowed costs under the Docket 7460 rate moderation plan for Units 1 and 2. On March 18, 1991, the City Council of the City of El Paso, in a meeting to review the settlement proposal, voted to reject the proposal. As a result, the Company's case in Docket 9945 before the Texas Commission will proceed as discussed above, and the settlement proposal will, in accordance with the agreement of the parties, have no precedential or evidentiary value in the case.

Fuel Reconciliation Case — Docket 8588. In June 1989, the Company filed an application with the Texas Commission to reconcile its fuel expenses and revenues for the period August 1, 1985 through March 31, 1989, which included over $200 million in Texas fuel costs. Reconciliation was required by Texas Commission rules and the Commission's final order in Docket 7460. On August 15, 1990, the Texas Commission rendered its final order, which was modified in response to motions for rehearing and resulted in a refund to Texas customers, to be made over a twelve-month period, of approximately $7.1 million, plus interest at the Company's composite cost of capital. As a part of its order, the Texas Commission disallowed approximately $1.3 million of costs included in the Company's nuclear fuel expense during the reconciliation period, which costs were incurred by the Company in connection with a joint venture formed to secure supplies of uranium fuel for the Company's interest in Palo Verde. In the third quarter of 1990, the Company recorded a regulatory disallowance of approximately $14.0 million, which represents fuel cost adjustments through March 1989, related adjustments through July 1990, interest on the refund, and approximately $4.2 million of unamortized costs related to the nuclear fuel joint venture, which, while not included in the fuel reconciliation case, were considered unrecoverable in future filings in light of the Commission's ruling in the fuel reconciliation case. The refund to customers began in February 1991. The Company and the City of El Paso have appealed the Texas Commission's order to state district court in Travis County, Texas. The Company expects a decision on the appeal by the end of 1991. The Company cannot predict the outcome of the appeal at this time.

Rate Case Expenses Incurred in Docket 7460. Expenses incurred by the Company and the City of El Paso in connection with Docket 7460 were severed from the issues ruled upon by the Texas Commission in that Docket and were assigned to a new Docket (8018) for consideration. The Company had applied for the immediate recovery of approximately $5 million of such expenses through a surcharge to customers and proposed that the balance of the expenses, attributable to the prudence phase of Docket 7460, be amortized and recovered in rates over the remaining life of the Palo Verde units. The hearing examiner's report recommended that the Company be reimbursed for approximately $10.6 million and that the City of El Paso be reimbursed for approximately $1.1 million of such rate case expenses, and that such amounts be surcharged to the Company's Texas customers over a one-year period. On August 15, 1990, the Texas Commission ordered additional hearings in Docket 8018 for the limited purpose of confirming certain evidentiary matters pertaining to approximately $7.4 million of such rate case expenses. Such hearings were held March 18, 1991. The Company expects a final ruling from the Texas Commission on the case in the summer of 1991. The expenses are included as a deferred charge in the Company's balance sheet. If such expenses were disallowed, which the Company does not expect, the expenses to the extent of the disallowance, would be charged to operations as a regulatory disallowance.

Texas Recognition of Palo Verde Sales and Leasebacks. In its Docket 8363 order and a separate order issued in August 1989, the Texas Commission found the Company's Unit 2 and Unit 3 sales and leasebacks to be in the public interest. The ruling, in the case of the Unit 3 sales and leasebacks, insures that the Commission will consider those transactions in connection with the Company's Unit 3 rate case. The City of El Paso appealed the Commission's order with respect to the Unit 3 transactions to state district court in Travis County, Texas. The appeal is not expected to be ruled upon this year. The Company believes that the court will uphold the Commission's order. The finding on the Unit 2 sales and leasebacks is a part of the City's appeal of the Docket 8363 order.

Performance Standards for Palo Verde — Texas. In June 1989, the Company filed an application with the Texas Commission to establish performance standards in its Texas jurisdiction for the operation of the Palo Verde units. On March 27, 1991, the Texas Commission issued its final order in the case, which resulted in standards based on a three-year rolling average of performance, applied on a unit specific basis. As a consequence, each Palo Verde unit will be evaluated annually, based upon a three-year rolling average capacity factor (the ratio of actual generation to maximum possible generation), against performance bands measured from a target capacity factor of 70%. The "deadband," where neither a penalty nor a reward would be triggered, runs from 62.5% to 77.5%. Penalties or rewards will result from worse or better performance, respectively, and will be calculated as a function of incremental replacement power costs. If a unit performs at an annual capacity factor of less than 35%, the staff of the Texas Commission is, under the performance standards, required to file a proceeding for the purpose of determining whether the unit should continue to be included in Texas rates. The Company does not believe that this requirement applies to the Unit 1 unscheduled outages in 1989 and 1990. If the requirement was interpreted to apply to such outages, the Company believes that the Texas Commission would find that Unit 1 should continue to be included in Texas rates. The standards are effective with the initial date of ratebase inclusion of the respective units. Therefore, such standards will cover, retroactively, the extended 1989 outages at Palo Verde. The Company calculates an initial penalty of approximately $2.8 million for Units 1 and 2. An additional penalty for Units 1 and 2 is projected for the second year of the standard's operation, based upon the use of the three-year rolling average. The Company estimates the entire penalties which will be sustained as a result of the 1989 Palo Verde outages is approximately $5 million; provision for loss for such penalties has been made in the Company's 1990 financial statements. The penalties will be credited to Texas customers through the next Texas fuel reconciliation filing. At least one of the intervenors in the case has indicated it will pursue an appeal.

Texas Recovery of Fuel Expenses. In its Texas jurisdiction, the Company recovers its fuel expenses and purchased power costs pursuant to a fuel factor set by the Texas Commission in each general rate request filed by the Company. The Texas Commission has the authority to order proceedings periodically for the purpose of reconciling the Company's fuel revenues against actual fuel expenses. As part of the Company's pending rate case in Docket 9945 (see discussion above in "Palo Verde

Unit 3"), the Company applied for reconciliation of its fuel costs, after giving effect to adjustments in Docket 8588, covering the period April 1989 through September 1990, and the establishment of a new fixed fuel factor. The Company requested that the Commission determine that the Company underrecovered its fuel costs during such reconciliation period by $11.4 million. Based on the decision in the Texas performance standards case discussed above, the Company has filed a request to withdraw its request for a fuel reconciliation from Docket 9945 and to refile a new fuel reconciliation case, incorporating the performance standard penalties.

New Mexico Rate Matters

In March 1987, the New Mexico Commission adopted a rate moderation plan which provides for the regulatory treatment of the New Mexico jurisdictional portion of the Company's investment in all three units at Palo Verde, with Unit 3 being deregulated. Similar to the Texas plan for Units 1 and 2 (Docket 7460 described above), the New Mexico plan provides that, to the extent the Company's base revenue requirements determined by the New Mexico Commission exceed the base rate increase provided for the period, the unrecovered revenue requirements are deferred for collection in later years of the plan. SFAS No. 92, which governs accounting for rate phase-in plans, was not in existence at the time of the adoption of the New Mexico plan. As a result of the New Mexico plan provision that deferrals not recovered prior to December 31, 1994 will not be recovered in New Mexico rates, the New Mexico plan does not comply with SFAS No. 92. The Company filed an application with the New Mexico Commission, requesting that the plan be amended to bring it into compliance with SFAS No. 92. On August 3, 1990, the New Mexico Commission denied the Company's request. As a result, the Company recorded at June 30, 1990 a write-off, net of tax, of approximately $5.1 million of recorded phase-in deferrals and has discontinued reporting for financial statement purposes the unrecovered revenue requirements deferred for collection under the plan. However, to the extent the Company's base rates in New Mexico exceed its New Mexico base revenue requirements during the term of the New Mexico plan, the Company is entitled to collect such differences in cash rates, for application to unrecovered revenue requirements pertaining to earlier years of the plan. A stipulated settlement of the scheduled third base rate increase under the plan was approved by the New Mexico Commission effective May 1, 1990. The Commission's order provided for an increase in base rates of approximately $1.8 million and deferral of approximately $0.7 million. The Company had requested an increase in base revenues of approximately $8.5 million.

The Company will be required to recover the New Mexico jurisdictional portion of the Company's investment in Unit 3, which is deregulated under the New Mexico rate moderation plan, through off-system sales in the economy energy market. Market prices for economy energy sales have not been in recent years, and are not presently, at levels sufficient to recover the New Mexico portion of the Company's current operating expenses related to Unit 3, including lease payments. However, the Company believes that over the useful life of Unit 3, based upon its current forecast of plant operating costs and performance, power needs of other utilities and alternative fuel prices, the Company will be able to recover the New Mexico portion of its Unit 3 costs through such sales of power.

The Company is subject to performance standards in its New Mexico jurisdiction for the operation of the Palo Verde units. The standards measure performance of the three units annually, viewed as a single generating station, against designated levels of capacity factors. If the annual capacity factor of the station exceeds 75% capacity, the Company is entitled to a monetary reward based upon the additional fuel costs avoided, calculated with reference to the Company's weighted average fuel and purchased power costs (other than Four Corners, Palo Verde and purchases from Southwestern Public Service Company). If the annual capacity factor falls below 60% capacity, the Company is penalized based upon the additional fuel costs incurred using the same formula. If annual performance falls between 60% and 75%, no consequences result. In 1990, the Palo Verde units performed within this deadband and the Company did not experience any penalties or rewards.

In its New Mexico jurisdiction, the Company recovers its fuel expenses and purchased power costs through a fuel factor set by the New Mexico Commission. The New Mexico rate moderation plan requires that the fuel factor be fixed each year during the term of the plan. On January 31, 1990, the Company filed a request for a new fuel factor in its New Mexico jurisdiction. The requested fuel factor reflected an estimated penalty of $3 million recorded by the Company in 1989 under the New Mexico performance standards governing the operation of Palo Verde as well as a request by the Company to recover during 1990 approximately $2 million of under-recovered fuel expenses. The Company subsequently amended its request to reduce the performance penalty to approximately $1.5 million. On May 21, 1990, the New Mexico Commission issued its final order accepting the Company's revised performance penalty of $1.5 million and granted the Company's requested under-recovery of fuel expenses of $2 million. The Company offset the performance penalty against the under-recovered fuel expenses.

FERC Rate Matters

The Company's rates for wholesale power sales and transmission services are subject to regulation by the FERC. The Company's sales for wholesale power make up a significant portion of the Company's operating revenues. During both 1990 and 1989, approximately 17% of the Company's electric operating revenues resulted from such sales. Rate tariffs currently applicable to certain FERC jurisdictional customers contain appropriate fuel and purchased power cost adjustment provisions designed to recover the Company's fuel and purchased power costs. Two FERC customers have fixed fuel factors approved under FERC tariffs for which no fuel reconciliation is made. Although rates to wholesale customers require FERC approval, the Company and its wholesale customers usually establish such rates through negotiations subject to such FERC approval.

The Company has a long-term firm power sales agreement with IID providing for the sale of 100 MW of firm capacity to IID through April 2002. In addition, the agreement calls for contingent capacity of 50 MW to be made available to IID beginning in 1992 and continuing through April 2002. The terms of the agreement generally provide for sales prices designed to fully recover the scheduled costs over the life of the agreement. The sales prices are generally level throughout the term of the agreement. Because of the levelized rate, costs will exceed revenues in the early years of the agreement. Amounts accrued under the terms of the agreement were $5,808,000, $7,340,000 and $7,632,000 in 1990, 1989 and 1988, respectively. Such accruals, which aggregate $22,290,000 as of December 31, 1990, are recorded as a long-term contract receivable on the Company's balance sheets.

The Company has a firm power sales agreement with TNP, providing for sales to TNP ranging from 68 MW to 79 MW through 2002, with negotiated demand charge rates for such power.

The agreements with IID and TNP settle any possible issue of the prudence of the construction costs of Palo Verde and of excess generating capacity and includes all of the Company's generation facilities in rates.

C. Liquidity

The Company's liquidity condition is primarily affected by two factors. First, escalating operating expenses, consisting primarily of operation and maintenance expenses of the Palo Verde Station and of Arizona property taxes, have adversely affected the operation of the Company's Texas and New Mexico rate moderation plans due to the fixed level of cash rate increases provided under such plans. Second, the Company continues to finance the costs of owning and operating Unit 3, which began commercial operation in January 1988, but will be considered for the first time for inclusion in Texas rates in Docket 9945, which is expected to be concluded in the fourth quarter of 1991. See Note B.

As discussed below, the Company's liquidity is dependent upon its access to adequate sources of external financing. The Company's access to external financing is ultimately dependent upon an outcome of Docket 9945 which provides sufficient operating revenues, earnings and cash flows, including a return on and recovery of the Company's plant investment in PVNGS Unit 3. Although the Company believes it is entitled to the rate relief sought in Docket 9945, the outcome of the Docket cannot presently be determined. See Note B.

The Company's financing capability has been significantly limited due to the cumulative effect of past rate orders, primarily under its Texas rate moderation plan, which have included substantial regulatory disallowances, resulting in an erosion of common equity, and revenue increases substantially less than the Company's revenue requirements, which have reduced phase-in deferrals. See Note B.

The Company will be required to finance in 1991 all of the following: $38.0 million for construction expenditures, $95.6 million for long-term debt maturities and preferred stock redemptions and $44.3 million for existing and requested regulatory deferrals. The 1991 financing requirements assume rate relief in Docket 9945 effective late in the fourth quarter of 1991. The impact of such rate relief in 1991 would not, therefore, be significant. However, the Company may seek to place a portion of its requested cash rate relief into effect under bond, subject to refund, as of mid summer, which, if implemented, would have a favorable impact upon 1991 financing requirements.

The Company's current financing plan for 1991 contemplates secured long-term financings of $75.0 million (to be applied to reduce the then outstanding short-term borrowings under the RCF or a similar facility, replacing the RCF), short-term borrowings under the RCF of $102.9 million and an extension of the May 31, 1991 maturity of the debt owed by the Company's fuel oil trust through a period of time corresponding to the extension period of the RCF (see discussion below). The Company believes, but has no assurance, that, assuming the RCF is extended through November 1991 as discussed below, the bank lender to the fuel oil trust will agree to the extension of the maturity of the fuel oil trust debt. If the maturity of such debt is not extended, the Company will be required to retire the $8.7 million owed by the fuel oil trust, which would increase the Company's financing requirements in 1991.

RCF. The Company relies upon the RCF for substantially all of its short-term borrowing capacity. The RCF, which involves a syndicate of money center banks, provides for borrowings by the Company from time to time through May 31, 1991, the termination date of the RCF, of up to $150 million outstanding at any one time. Borrowings under the RCF bear interest at a floating rate based upon bank prime rate or, at the option of the Company, premiums above adjusted certificate of deposit and LIBOR rates. The May 31, 1991 termination date was set with reference to the then expected timing of the Texas Commission's order in Docket 9945. That order is now not expected until the fourth quarter of 1991. The Company is, therefore, seeking an extension of the RCF through November 1991 to continue to meet financing requirements. The Company believes that the RCF banks will grant the requested extension, but there can be no assurance that the extension will be granted. In the absence of an extension of the RCF beyond May 31, 1991, the Company would be required to seek alternative sources of financing in order to be able to continue to meet its obligations. The Company cannot predict whether such alternative financing, if required, could be obtained in the required time frame.

The Company will require short-term borrowings in 1992 under the RCF or an alternative source of financing. The Company will, therefore, request an additional extension of the RCF through at least

1992, which request the Company expects the RCF banks to consider in light of the Texas Commission's final order in Docket 9945.

It is an event of default under the RCF if the Texas Commission renders a decision with regard to the Company's investment in Unit 3 which, in the judgment of the RCF Banks, causes the Company's revenues to be insufficient to assure (1) the Company's ongoing viability, (2) its access to capital markets or (3) its ability to refinance or repay obligations when due. The outcome of Docket 9945 cannot be predicted. See Note B.

The RCF must be collateralized at all times with at least Second Mortgage Bonds of the Company in an aggregate principal amount equal to the committed amount of the RCF. At the present time, the RCF is collateralized by $100 million of Second Mortgage Bonds of the Company and $50 million of First Mortgage Bonds of the Company. As the First Mortgage Bonds are needed by the Company as a source of long-term financing, the RCF Banks are required to release the First Mortgage Bonds as collateral in an amount equal to the amount of Bonds needed by the Company for the long-term financing, and the Company is required to substitute for the amount of such released First Mortgage Bonds an equal amount of Second Mortgage Bonds. See "1991 Long-Term Financing" below.

The RCF requires that the Company meet specified fixed charge and maintenance of equity ratios, maintain specified long-term debt issuance capacity and meet certain maintenance of collateral value tests.

The fixed charge ratio requires that the Company maintain a specified ratio of cash flow (as defined) to interest charges and operating lease payments. The ratio is determined quarterly and is calculated on a rolling 12 months. The Company maintained a ratio of 1.23 to 1 for the 12 months ended December 31, 1990, as compared to the required ratio for that period of 1.1 to 1. For the 12 months ending March 31, 1991, the Company is required to maintain a ratio of at least 1.1 to 1. If the RCF is extended in accordance with the Company's request described above, the Company expects the ratio for the 12 months ending June 30, 1991 and September 30, 1991 to be 1.1 to 1 and 1.15 to 1, respectively. The Company expects to remain in compliance with this required ratio through the extension period requested by the Company.

The maintenance of equity test requires that the Company maintain at all times equity (the sum of the Company's common stock equity and preferred stock *minus* intangibles *plus* losses from discontinued operations (net of taxes) recognized in 1989) of not less than 23% of the Company's capitalization (the sum of its equity (as calculated above) *plus* indebtedness of the Company and the present value of the operating lease payments on Palo Verde Units 2 and 3). On December 31, 1990, the Company met the maintenance of equity test with a ratio of 26.0% and expects to remain in compliance through the extension period.

The long-term debt issuance capacity test requires that the Company at all times have the capacity to issue mortgage bonds in an amount sufficient to repay maturing debt and provide for an additional $100 million of mortgage bond financing. Issuance capacity includes the Company's capacity to issue bonds under its First and Second Mortgage Indentures plus the unutilized committed amount of the RCF. The Company is required to maintain a ratio of capacity to required debt maturities *plus* the $100 million of at least 1 to 1. On December 31, 1990, the Company met the test with a ratio of 1.65 to 1. The Company will require and has requested from the banks a reduction in the ratio during the extension period of the RCF requested by the Company. The Company believes, but has no assurance, that the banks will, if the extension of the RCF is granted as requested by the Company, also grant the requested reduction in the issuance capacity ratio.

The collateral coverage ratio requires that the ratio of the book value of the Company's net plant in service (as defined on the Company's balance sheet minus financing and capital lease obligations and excepted property under the mortgage indentures) and construction work in progress *minus* the aggregate principal amount of First Mortgage Bond indebtedness outstanding to the aggregate principal amount of Second Mortgage Bond debt outstanding be at least 2 to 1. At December 31, 1990, the Company met this test with a ratio of 2.61 to 1. The Company expects to remain in compliance with this test through the extension period requested by the Company.

Failure to meet any of the above ratios and tests would constitute a default under the RCF, which, unless such default was waived or the ratio or test was amended so that the Company complied with the ratio or test as amended, would entitle the RCF banks to accelerate the indebtedness owing under the RCF and demand its immediate repayment.

The RCF prohibits the Company from paying any dividend on common stock.

The RCF restricts incurrence of indebtedness by the Company, other than under the RCF to (1) borrowings up to $50 million under the nuclear fuel trust credit facility described below, (2) indebtedness which is unsecured, or junior in right of security to the RCF, and which does not require principal amortization prior to the then termination date of the RCF, (3) scheduled long-term financing by the Company, including long-term financings which were required under the RCF, which the Company has successfully completed, and (4) refundings, renewals, extensions and replacements of maturing indebtedness.

Approximately $54 million was available for borrowing under the RCF at March 29, 1991.

1991 Long-Term Financing. To meet its 1991 long-term financing requirements, the Company has commitments from prospective purchasers, which are subject to certain conditions to closing, including the absence of material adverse changes in the Company's financial condition, for the purchase of $50 million of fixed interest rate First Mortgage Bonds and $25 million of fixed interest rate Second Mortgage Bonds. In order to remain within the borrowing limit of the RCF, these transactions are scheduled to and must close by June 1, 1991. The Company will be required, as a condition to the issuance of these Bonds, to obtain the approval of the RCF banks of the Company's 1991-1992 financing plans.

The $50 million of First Mortgage Bonds will be issued based upon the release by the RCF Banks of the $50 million of First Mortgage Bonds presently held as collateral under the RCF. Such released Bonds will constitute retired bonds under the First Mortgage Indenture, which means that the $50 million of First Mortgage Bonds to be issued and sold this year can be issued without the Company being required to meet the net earnings test of the First Mortgage Indenture. See discussion below regarding issuance of additional First Mortgage Bonds.

The Company will be required to replace the First Mortgage Bonds released under the RCF with $50 million of Second Mortgage Bonds. The $25 million of Second Mortgage Bonds to be issued and sold by June 1, 1991, together with the $50 million of Second Mortgage Bonds to be substituted as collateral under the RCF, will be issued on the basis of retired bonds and property additions under the Second Mortgage Indenture. See discussion below regarding issuance of additional Second Mortgage Bonds.

1992 Financing Requirements. Estimated 1992 capital requirements are $52.1 million for construction expenditures and $61.2 million for long-term debt maturities and preferred stock redemptions. The Company's current 1992 financing plan contemplates long-term financings of $75 million (to be applied to reduce the then outstanding short-term borrowings) and short-term borrowings of $31.9 million. The Company will seek to meet its long-term financing requirements in 1992 through the issuance of additional First Mortgage Bonds and Second Mortgage Bonds. However, assuming that the 1991 long- term financings with First Mortgage Bonds and Second Mortgage Bonds discussed above are closed, the Company will not have any significant financing capacity under its Second Mortgage Indenture, unless the Company were to reduce the committed amount of the RCF, which the Company would not be able to do, and the Company's capacity to finance under the First Mortgage Indenture would be dependent upon the earnings levels that result from the outcome of Docket 9945. See discussion below regarding issuance of additional First Mortgage Bonds and Second Mortgage Bonds.

The Company is exploring alternative sources of long-term debt financings. Such financings could include receivables financing, convertible unsecured debentures, and securitization of contract and other rights to future cash payments, including regulatory deferrals. The Company believes, but there can be no assurance, that the Company will be able to secure alternative sources of long-term financing for 1992, should the Company not have sufficient financing capacity under the First Mortgage Indenture and the Second Mortgage Indenture.

Factors Affecting Ability to Finance. As indicated above, the Company's access to adequate sources of external financing, as well as the magnitude of the Company's ongoing requirements for financing, is dependent upon the ultimate outcome of the Texas rate case in Docket 9945. Although the Company believes that it is entitled to the rate relief sought in Docket 9945, if that Docket does not provide sufficient operating revenues, earnings and cash flows, including a return on and recovery of the Company's plant investment in PVNGS Unit 3, or if the Docket was to result in significant additional regulatory disallowance, which the Company does not expect, the Company's results of operations will be adversely affected and the Company's access to capital markets for the financing that the Company will require will be restricted and, depending on the circumstances, could be eliminated. See Note B.

The credit ratings on the Company's senior securities are below investment grade level. On March 19, 1991, Standard & Poor's Corporation lowered its ratings on the Company's senior securities as follows: First Mortgage Bonds to "BB−" from "BB+", senior unsecured debt and lease obligations to "B" from "BB−", and preferred stock to "CCC" from "BB−". Standard & Poor's indicated that the downgradings reflected the rejection by the City of El Paso of the Company's proposal for the settlement of its Texas jurisdictional revenue requirements, the Company's current financial condition and prospects for financial recovery. In addition, there has been, recently, a general tightening of credit availability in the capital markets, particularly with respect to the placement of non-investment grade long-term debt. The non-investment grade ratings on the Company's senior securities significantly restricts the universe of potential investors. Although the Company believes that, despite the non-investment grade ratings on its senior securities and the general tightening of the credit markets, it will be able to place the long-term financing it requires, such factors could adversely affect the Company's ability to do so, depending upon the outcome of Docket 9945.

The letters of credit supporting the sales and leasebacks by the Company of its interest in Palo Verde Unit 2 expire December 31, 1991, and in the case of one sale/leaseback, January 2, 1992. Such letters of credit must be maintained in effect for the benefit of the related equity investors through at least December 31, 1999, and, in the case of one equity investor, through the basic lease term which expires October 1, 2013. All such letters of credit must be renewed or replaced prior to their expiration in order to avoid default under the related leases, which would entitle the equity investors to draw under the letters of credit. The aggregate amount of such letters of credit is $211.8 million. The renewal or replacement letters of credit must meet certain agreed upon criteria imposed by the equity investors, some of which differ from the terms and conditions of the existing letters of credit. Although the renewal or replacement of the letters of credit will probably require renegotiations with the issuing banks and perhaps the equity investors, the Company believes, but there can be no assurance, that it will be able to renew or replace the letters of credit as required. Failure to renew or replace the letters of credit could adversely affect the Company's access to capital markets for required financing and could, depending upon the circumstances, eliminate that access.

The letters of credit supporting the Company's sales and leasebacks of interests in Palo Verde Unit 3 expire at December 31, 1992. Such letters of credit aggregate $87.5 million and are required to be maintained throughout the basic lease term of the related leases, which expires January 2, 2017. The Company expects that the letter of credit agreements providing for the Unit 3 letters of credit will be renegotiated to the same effect and at the same time as the Unit 2 letters of credit are renegotiated. Such renegotiated terms could, but are not anticipated to, require the consent of the related Unit 3 equity investors.

The Unit 2 and Unit 3 letter of credit agreements and one other bank credit agreement require the Company to meet the same maintenance of equity and fixed charge ratios required to be met under the RCF. The leases and other transaction documents for the Palo Verde Unit 2 sales and leasebacks contain incurrence of debt restrictions which are suspended for so long as complying letters of credit remain in effect. Because the Company expects to be able to maintain complying letters of credit in effect as required under the Unit 2 transaction documents, it does not expect the Unit 2 incurrence of debt restrictions to affect its financing capacity.

Due to the earnings test required to be met under the Company's Restated Articles of Incorporation, losses incurred in 1990 and the outlook of results of operations for 1991 and for a period of time thereafter, the Company anticipates that it will not be able to issue any additional preferred stock in 1991 and for a period of time thereafter without the consent of the holders of a majority of the shares of preferred stock then outstanding.

The Company's Restated Articles of Incorporation provides that, unless consented to by a majority of the shares of preferred stock then outstanding, the aggregate of unsecured long-term debt shall not exceed 10% of the total of the Company's outstanding secured debt, capital and surplus. At December 31, 1990, the Company was permitted to issue approximately $89.6 million in additional unsecured long-term debt.

The Company's First Mortgage Bond Indenture limits the amount of additional First Mortgage Bonds which can be issued. Under the Indenture, the Company may issue additional First Mortgage Bonds (a) to the extent of 60% of the value of unfunded net additions to the Company's utility property, provided net earnings available for interest during a recent twelve-month period were at least twice the annual interest requirements on all bonds to be outstanding and on all prior lien debt and (b) to the extent of the principal amount of retired bonds without, under certain circumstances, being required to meet the earnings test. The Company cannot presently issue additional First Mortgage Bonds on the basis of the net earnings test described in clause (a) and will not be able to issue in 1991 additional First Mortgage Bonds on the basis of such test. The Company's ability to issue in 1992 additional First Mortgage Bonds on the basis of the net earnings test is dependent upon the outcome of the Company's rate case in Docket 9945 as discussed above. The RCF is secured in part by $50 million of First Mortgage Bonds. The RCF provides that, as the Company issues and sells First Mortgage Bonds to meet the long-term financing requirements of the RCF, First Mortgage Bonds held as collateral for the RCF are required to be released to the Company in an amount equal to the proposed financing; subject to the requirement that the RCF must at all times be secured by First and/or Second Mortgage Bonds issued in an aggregate amount equal to the $150 million commitment of the RCF. Such released bonds constitute retired bonds under the Company's First Mortgage Indenture and, therefore, would be available as the basis for the issuance of additional First Mortgage Bonds under the Indenture in an amount equal to the principal amount of the released bonds. See "1991 Long-Term Financing" above.

Under the Company's Second Mortgage Indenture, the Company may issue additional Second Mortgage Bonds (a) on the basis of 40% of the value of unfunded net additions to the utility property and (b) to the extent of the principal amount of retired bonds. At December 31, 1990, unfunded net additions totaled $47.5 million, which was sufficient with the inclusion of $70 million in credits for bonds retired in February 1991, to permit the issuance of approximately $89 million principal amount of new Second Mortgage Bonds.

Short-term borrowings by the Company are limited to amounts approved by the FERC. The Company's current authorization from the FERC for short-term debt, including borrowings under the RCF and the nuclear fuel credit facility, provides for up to $200 million of short-term debt, with maturities no later than December 31, 1991. The Company will file in the near future for an extension of the FERC authorization through December 31, 1993, providing for at least $200 million of short-term borrowings. The Company believes, but has no assurance, that the FERC will grant the requested authorization.

The credit facility supporting the independent trust established to meet the Company's nuclear fuel requirements provides for short-term borrowing by the Company. To accomplish the borrowings, the trust may borrow under the credit facility available to it to meet the nuclear fuel acquisition requirements, to the extent that such borrowings are not then needed by the trust to meet those requirements, and then loan the funds to the Company. At March 30, 1991, the Company owed the trust under this arrangement approximately $9.8 million. The bank lender to the trust has requested that the Company not borrow any additional funds from the trust and that the Company consider retiring the present outstanding borrowing. If the Company were required to retire the borrowing, the Company's 1991 financing requirements would increase by a corresponding amount. The Company does not intend to attempt additional borrowings from the trust pending the outcome of ongoing discussions with the bank. The bank has given a notice, as permitted under the credit facility, which establishes the termination of the credit facility on January 8, 1993. Absent renegotiation of the facility, the Company will be required to refinance or retire at that time the trust's obligations to the bank.

D. Palo Verde Nuclear Generating Station

A summary of the Company's 15.8% investment in the three 1270 MW nuclear generating units which comprise Palo Verde Station and investment in other jointly owned utility plant, excluding fuel, is as follows:

	Electric Plant in Service	Accumulated Depreciation	Construction Work in Progress
December 31, 1990:			
Palo Verde Station	$905,184,000	$(54,249,000)	$ 23,724,000
Other	125,733,000	(34,598,000)	6,332,000
December 31, 1989:			
Palo Verde Station	$656,416,000	$(40,290,000)	$228,228,000
Other	125,090,000	(29,750,000)	5,660,000

The Company's investment, at cost, in the Palo Verde Station in the amount of $928,908,000 at December 31, 1990 excludes amounts which represent the book value of the Company's investment in Palo Verde Station which was sold and leased back during 1986 and 1987 and for which the related leases are accounted for as operating leases. See Note E of Notes to Financial Statements for information regarding such transactions and the Company's lease obligations relating thereto.

Decommissioning and Spent Nuclear Fuel

The Company is required to plan and fund its share of the estimated costs to decommission Palo Verde, including the portions sold and leased back. The Company has assessed the requirements for the funding of such decommissioning and has determined, based upon an independent study, that the Company will have to fund approximately $120 million (stated in 1989 dollars) for decommissioning of its share of Palo Verde. The Company will fund decommissioning over the estimated service life (approximately 40 years) for the portion of its owned interest in Palo Verde and over the term of the related leases (27 to 29 years) for the sold and leased back portions of Palo Verde. The Company has established decommissioning trust funds for its share of Palo Verde Units 1 and 2 in all jurisdictions, and Unit 3 for its FERC jurisdiction. The Texas portion of funding for Unit 3 is not currently taking place as it is not yet in Texas rates, but, the Company believes that the Texas jurisdiction will fund its share of decommissioning requirements for Unit 3. The Company must fund the decommissioning requirements for its New Mexico jurisdictional portion of Unit 3 through off system sales of economy energy as this portion of Unit 3 is deregulated. Because the Company is under fixed price contracts with its FERC customers, the amount of decommissioning received in current rates is not sufficient to fund the FERC portion of decommissioning, and therefore, the Company must fund this shortfall.

The Company is currently funding its share of the obligation for spent nuclear fuel costs associated with Palo Verde through payments to the operating agent of Palo Verde of one dollar per net MWH generated as prescribed by the DOE.

E. Sale and Leaseback Transactions

In August and December 1986 and December 1987, the Company consummated ten separate sale and leaseback transactions involving all of its 15.8% undivided interest in Palo Verde Unit 2, one-third of its undivided interest in certain Common Plant at Palo Verde and approximately 40% of its undivided interest in Unit 3. The Company remains responsible, during the terms of the leases, for all operating and maintenance costs, nuclear fuel costs, and other related operating costs of the leased-back facilities, and for decommissioning costs.

The aggregate consideration received by the Company in the sale and leaseback transactions was $934.4 million ($684.4 million in 1986 and $250.0 million in 1987). The proceeds from the transactions, which were based upon appraised fair market value, exceeded the cost of the assets sold by $194.0 million, which amount has been deferred and is being amortized into income, as a reduction to lease expense, over the primary terms of the leases. Nine of the ten transactions are accounted for as operating leases; one transaction (sales price of $87.4 million), with an affiliate of a federal savings and loan association is accounted for as a financing transaction. During 1987, the Company acquired $60 million of newly issued, floating rate exchangeable preferred stock of the savings and loan association, which was subsequently disposed of at a total loss during December 1989. (See Note P.) Additionally, an affiliate of the savings and loan association received placement fees aggregating approximately $3.7 million in connection with the ten sale and leaseback transactions and the preferred stock transaction.

Leases related to Unit 2 and Common Plant expire in October 2013, while leases related to Unit 3 expire in January 2017. All of the leases contain certain renewal options and provide for repurchase options, at fair market value, at the termination of the lease. Additionally, all of the leases provide that upon the occurrence of specified events of loss or deemed loss events, as defined, the Company is obligated to pay the related equity investor an amount in cash which, primarily because of certain tax consequences, may exceed the equity investor's unrecovered equity investment. Upon payment of such amount and assumption of the debt portion of the purchase price of the undivided interest, the undivided interest will be transferred to the Company. Approximately 20% of the aggregate purchase price of the undivided interests sold in the sale and leaseback transactions was provided by the equity investors, with the balance being provided through the issuance of non-recourse debt by the lessor/purchasers. Additionally, the Company has agreed to indemnify the lessors in certain circumstances against certain losses, including the loss of certain tax benefits, resulting from specified events.

During 1990, 1989 and 1988, lease expense under the leases accounted for as operating leases amounted to $88,207,000, $85,670,000 and $83,891,000, respectively, of which $15,901,000, $16,041,000 and $26,315,000, respectively, were deferred and capitalized. Future minimum annual rental payments required under such leases are as follows (in thousands):

Year ending December 31,	
1991	$ 82,627
1992	82,627
1993	82,627
1994	82,627
1995	82,627
Thereafter	1,537,305

F. Other Short-Term Investments

As of December 31, 1989 the Company had sold all of its short-term investments.

Net realized losses on investments included in the determination of net income were $1,389,000 and $4,014,000 for 1989 and 1988, respectively. The cost of the securities sold was based on the actual cost of each such security at the time of sale.

Investment income in 1990 consists primarily of interest earned on repurchase agreements. Investment income in 1989 and 1988 consisted of dividends on common stock, and interest earned on mortgage-backed securities. 1989 investment income also includes interest earned on repurchase agreements and a provision for estimated loss on an investment in annuities.

G. Deferred Charges and Other Assets

Other deferred charges and other assets consisted of the following at December 31 (In thousands):

	1990	1989
Rate case costs	$18,240	$16,716
Deferred employee benefit costs	11,169	10,689
Financing and transaction costs	20,200	19,879
Annuities	12,342	12,342
Palo Verde outage costs	6,428	4,574
Other	17,384	13,856
	$85,763	$78,056

H. Common Stock

In May 1989, the Board of Directors eliminated the second quarter 1989 common stock dividend. No common stock dividends have been paid since then. The Board based its decision to eliminate the dividend upon, among other things, results of operations, financial condition and cash flow. The Company believes that common stock dividends will not be resumed prior to 1993. Additionally, the terms of the Company's RCF borrowing facility prohibit the Company from paying any common stock dividend, and the Company expects that any extension of the RCF beyond its present termination date of May 31, 1991, would continue to prohibit the payment of common stock dividends. See Note C.

Employee Stock Purchase Plan

The Company has an employee stock purchase plan under which eligible employees are granted options twice each year to purchase, through payroll deductions, shares of common stock from the Company at a specified discount from the fair market value of the stock; provided, however, that if the option price exceeds the fair market value of the stock on the date of exercise of the option, the Company, in lieu of selling the stock at the option price, purchases in the over-the-counter market, for the accounts of the participants, that number of shares of common stock as the aggregate of the payroll deductions under the plan will purchase.

Employee Stock Compensation Plan

The Company has a broad-based employee stock compensation plan under which shares of Company common stock are issued from time to time to eligible employees. Under the plan, the Board's Compensation/Benefits Committee may direct the issuance from time to time of Company common stock to compensate employees for past services rendered to the Company or to pay for various employee benefits with common stock rather than with cash, including the Company's contribution under the Company's Savings Plans (described below).

Employee Stock Option Plan

The Company's Employee Stock Option Plan was approved by the Board of Directors in December 1987 and received shareholder and regulatory approval in 1988. Following amendment in 1990 to approve an increase in the number of shares available, the plan authorizes the issuance of up to 3,000,000 shares of common stock pursuant to options which may be granted at not less than fair market value.

The Board of Directors has authorized the allocation of the common stock options as follows:

Date of Options	Option Price	Number of shares
August 23, 1989	$8.875	325,600
January 24, 1990	8.625	100,000
March 27, 1990	8.375	145,800
May 21, 1990	7.250	50,000
November 19, 1990	3.875	912,400
Total shares of common stock options allocated		1,533,800
Total options exercisable at December 31, 1990		849,500

The options granted November 19, 1990 are exercisable in installments, with 25% of the options exercisable immediately and an additional 25% exercisable each full year from the date of the award. All other options granted were exercisable immediately. All common stock options granted have a ten-year expiration period from the date of the award, subject to earlier termination in the event of termination of employment, death, total and permanent disability or dissolution or liquidation of the Company. The plan also provides for stock appreciation rights if there is a change of control of the Company, as defined in the plan. Options are granted at the discretion of the Compensation/Benefits Committee of the Board and are based generally on a percentage set by the Committee of the eligible employee's salary. Options covering 109,507 shares that were granted in November 1988 were cancelled effective March 27, 1990 pursuant to Cancellation Agreements entered into with each holder of the outstanding options and new options were granted as of August 23, 1989 and March 27, 1990. As of December 31, 1990, none of the options had been exercised.

Changes in common stock are as follows:

	Common Stock Shares	Common Stock Amount (In thousands)
Balance December 31, 1987	34,972,180	$334,299
Issuances of Common Stock:		
1988	103,129	1,468
1989	125,958	1,409
1990	150,944	1,126
Balance December 31, 1990	35,352,211	$338,302

Shares of common stock reserved for issuance under the above described stock benefit plans were 3,526,007 at December 31, 1990.

Shareholder Rights Plan

On September 5, 1990, the Board of Directors of the Company declared, subject to regulatory approval of FERC and the New Mexico Commission, a dividend distribution of one share purchase right ("Right") for each share of common stock of the Company outstanding on the later to occur of (a) the date on which the order of the FERC approving the issuance of the Rights become final and nonappealable and (b) the date on which the order of the New Mexico Commission approving the issuance of the Rights becomes final and nonappealable (such later date being hereinafter referred to as the "Effective Date"). The Rights Agreement under which the Rights are to be issued provides for the issuance under certain circumstances of one Right for each share of common stock that becomes outstanding after the Effective Date. The Company has reserved 39,000,000 shares of common stock, subject to adjustments, for issuance upon exercise of Rights. The required regulatory approvals have not been obtained; thus, the dividend distribution to shareholders of the Rights has not been made. Each Right will entitle the holder thereof to purchase from the Company one share of common stock of the Company at a price of $25 per share, subject to adjustment as provided in the Rights Agreement. The Rights will be exercisable only if a person or group acquires 15% or more of the Company's common stock or a tender offer for 30% or more of the Company's common stock is commenced. Under certain circumstances, upon a shareholder acquisition of 15% or more of the Company's common stock, each Right will entitle the holder to purchase, at the Right's then-current exercise price, a number of shares of common stock of the Company having a market value of twice the Right's exercise price. The acquisition of the Company pursuant to certain mergers or other business transactions will entitle each Right to purchase, at the Right's then-current exercise price, a number of the acquiring Company's common shares having a market value at that time of twice the Right's exercise price. The Rights held by certain 15% shareholders will not be exercisable. The Rights will expire on September 5, 2000 and are subject to redemption at $0.01 per Right under certain circumstances.

I. Preferred Stock

Under certain provisions of the Federal Power Act regarding the payment of dividends on capital stock, the Company would, as those provisions are interpreted by the staff of the FERC, be allowed to pay dividends on its capital stock only out of retained earnings. Although the Company does not believe it is probable that significant additional write-offs from regulatory disallowances will occur, if such write-offs do occur and result in a deficit in the Company's retained earnings account, the Company would, under the FERC staff interpretations, be required to suspend the payment of dividends, and as a result sinking fund payments, on its preferred stock until the deficit is eliminated. The Company could, with the approval of the Company's common shareholders, effect an accounting reorganization of its common stock equity account to eliminate such deficit. Earnings generated after the elimination of such deficit would be an available source for the payment of dividends on capital stock.

Additionally, depending upon the Company's ongoing assessment of its liquidity condition, and in particular, the outcome of Docket 9945, there can be no assurance that the Board of Directors will not at some future point have to consider the reduction or elimination of the preferred stock dividends, and as a result sinking fund payments. See Notes B and C.

Preferred Stock, Redemption Required

Following is a summary of issued and outstanding preferred stock, redemption required:

	December 31,				Optional Redemption Price Per Share at December 31,
	1990		1989		1990
	Shares	Amount (In thousands)	Shares	Amount (In thousands)	
$10.75 Dividend	56,000	$ 5,600	60,000	$ 6,000	$102.500
$ 8.44 Dividend	97,600	9,760	103,600	10,360	104.220
$ 8.95 Dividend	90,000	9,000	97,500	9,750	104.480
$ 9.50 Dividend	—	—	46,000	4,600	—
$10.125 Dividend	150,000	15,000	200,000	20,000	102.250
$11.375 Dividend	400,000	40,000	500,000	50,000	103.920
	793,600	$79,360	1,007,100	$100,710	

Each series of preferred stock, redemption required, is entitled to the benefits of its respective annual sinking fund which requires redemptions of a specified number of shares or a percentage of outstanding shares. The sinking fund redemption price on all series is $100 per share plus accrued dividends.

Each series, other than the $10.75 series, is redeemable at the option of the Company at various stated redemption prices. Optional redemptions are also generally restricted as to the timing of redemption when such redemptions are part of or in anticipation of any refunding involving the issue of indebtedness or preferred stock having an effective interest cost or effective dividend cost of less than the stated dividend rate of each preferred stock series.

Sinking fund requirements for each of the above series are cumulative and, in the event they are not satisfied at any redemption date, the Company is restricted from paying any dividends on its common stock (other than dividends paid in shares of common stock or other class of stock ranking junior to the preferred stock as to dividends or assets).

The aggregate amounts of the above preferred stock required to be redeemed for each of the next five years are as follows (in thousands):

1991	$16,750
1992	16,750
1993	16,750
1994	11,750
1995	1,750

Redemptions of preferred stock, redemption required were as follows:

	Shares	Amount (In thousands)
Balance at December 31, 1987	1,106,100	$110,610
Redemption of Preferred Stock, $10.75 Dividend	(4,000)	(400)
Redemption of Preferred Stock, $8.44 Dividend	(6,000)	(600)
Redemption of Preferred Stock, $8.95 Dividend	(7,500)	(750)
Redemption of Preferred Stock, $9.50 Dividend	(4,000)	(400)
Balance at December 31, 1988	1,084,600	108,460
Redemption of Preferred Stock, $10.75 Dividend	(4,000)	(400)
Redemption of Preferred Stock, $8.44 Dividend	(6,000)	(600)
Redemption of Preferred Stock, $8.95 Dividend	(7,500)	(750)
Redemption of Preferred Stock, $9.50 Dividend	(10,000)	(1,000)
Redemption of Preferred Stock, $10.125 Dividend	(50,000)	(5,000)
Balance at December 31, 1989	1,007,100	100,710
Redemption of Preferred Stock, $10.75 Dividend	(4,000)	(400)
Redemption of Preferred Stock, $8.44 Dividend	(6,000)	(600)
Redemption of Preferred Stock, $8.95 Dividend	(7,500)	(750)
Redemption of Preferred Stock, $9.50 Dividend	(46,000)	(4,600)
Redemption of Preferred Stock, $10.125 Dividend	(50,000)	(5,000)
Redemption of Preferred Stock, $11.375 Dividend	(100,000)	(10,000)
Balance at December 31, 1990	793,600	$ 79,360

Preferred Stock, Redemption not Required

Following is a summary of preferred stock issued and outstanding at December 31, 1990 which is not redeemable except at the option of the Company:

	Shares	Amount (In thousands)	Optional Redemption Price Per Share
$4.50 Dividend	15,000	$ 1,534	$109.00
$4.12 Dividend	15,000	1,506	103.98
$4.72 Dividend	20,000	2,001	104.00
$4.56 Dividend	40,000	4,000	100.00
$8.24 Dividend	52,450	5,157	103.40
	142,450	$14,198	

All preferred stock issues (redemption required and redemption not required) are entitled in preference to common stock, to $100 per share plus accrued dividends, upon involuntary liquidation. All issues are entitled to an amount per share equal to the applicable optional redemption price plus accrued dividends, upon voluntary liquidation.

J. Long-Term and Financing and Capital Lease Obligations

Outstanding long-term and financing and capital lease obligations are as follows:

	Redemption Price at December 31, 1990(1)	December 31, 1990	December 31, 1989
		(In thousands)	
Long-Term Obligations:			
First Mortgage Bonds(2):			
4⅝% Series, issued 1962, due 1992	100.21%	$ 10,385	$ 10,385
6¾% Series, issued 1968, due 1998	101.63	24,800	24,800
7¾% Series, issued 1971, due 2001	103.08	15,838	15,838
9% Series, issued 1974, due 2004	103.82	20,000	20,000
10½% Series, issued 1975, due 2005	105.51	15,000	15,000
8½% Series, issued 1977, due 2007	104.83	25,000	25,000
9.95% Series, issued 1979, due 2004	105.39	18,622	19,685
13¼% Series, issued 1984, due 1994	—	23,600	29,500
11.10% Series, issued 1990, due 2001	—	153,000	153,000
Second Mortgage Bonds(2):			
11.58% Series, issued 1990, due 1997	—	35,000	—
12.63% Series, issued 1990, due 2005	—	105,000	—
Pollution Control Bonds(3)(4):			
Secured by Second Mortgage Bonds(2):			
Variable rate bonds, due 2014, net of $1,585,000, and $1,499,000, respectively, on deposit with trustee		61,915	62,001
Variable rate refunding bonds, due 2014, net of $25,000, on deposit with trustee in 1989		37,100	37,075
Variable rate refunding bonds, due 2015		59,235	59,235
Unsecured:			
Variable rate, refunding bonds, due 2013, net of $3,680,000, and $3,482,000, respectively, on deposit with trustee		32,125	32,323
Floating rate notes secured by Second Mortgage Bonds(2)(5):			
Due 1991		70,000	70,000
Promissory notes:			
Unsecured (6):			
Due 1992		25,000	45,000
Total long-term obligations		731,620	618,842
Financing and Capital Lease Obligations:			
Financing obligation, Palo Verde Unit 2 ($1,153,000 due in 1991)(7)		80,339	81,394
Turbine lease ($1,438,000 due in 1991)(8)		11,291	11,675
Nuclear fuel ($36,036,000 due in 1991)(9)		66,922	48,460
Total financing and capital lease obligations		158,552	141,529
Total long-term and financing and capital lease obligations		890,172	760,371
Amounts due within one year:			
Current maturities		(115,590)	(49,100)
Unamortized discount and premium		(1,065)	(1,193)
		$ 773,517	$710,078

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(1) The premiums reflected in the redemption prices continue at reduced amounts in future years, finally resulting in each case in redemption at par in the final year prior to maturity.

(2) Substantially all of the Company's utility plant is subject to liens under the First and Second Mortgage Indentures.

The First Mortgage Indenture securing its First Mortgage Bonds provides for sinking and improvement funds. Except as otherwise noted, the Company is required to make annual payments to the trustee equivalent to 1%, $1,115,000 at December 31, 1990, of the greatest aggregate principal amount of such series outstanding prior to a specified date. The Company has generally satisfied the 1% requirements for such series by relinquishing the right to use a net amount of additional property for the issuance of bonds or by purchasing bonds in the open market and expects to continue these practices. With respect to the 9.95% series, commencing in April 1985 the Company is required to make annual cash payments to the trustee equivalent to 4.25%, of the greatest aggregate principal amount of such series outstanding at any one time prior to a specified date, $1,063,000 in 1990 and 1989; the cash payments must be applied to redeem bonds of the 9.95% series at 100% of the principal amount thereof. With respect to the 13.25% series, commencing in April 1990, the Company is required to make annual cash payments to the trustee equivalent to 20%, of the greatest aggregate principal amount of such series outstanding at any one time prior to a specified date, $5,900,000 in 1990; the cash payments must be applied to redeem bonds of the 13.25% series at 100% of the principal amount thereof. With respect to the 11.10% series, commencing in June and December 1995, the Company will be required to make semiannual cash payments to the trustee equivalent to 7.14% of the greatest aggregate principal amount of such series outstanding at any one time prior to a specified date, the cash payments must be applied to redeem bonds of the 11.10% series at 100% of the principal amount thereof.

In accordance with certain provisions of the First Mortgage Indenture, payments of cash dividends on common stock are restricted to an amount equal to retained earnings accumulated after December 31, 1966, plus $4,100,000. Retained earnings in the amount of approximately $14,577,000 are unrestricted as to the payment of cash dividends on common stock at December 31, 1990. However, under the RCF, the Company is restricted from declaring or paying any common stock dividends. See Note H.

The Second Mortgage Indenture securing its Second Mortgage Bonds provides for sinking funds. With respect to the 11.58% series, commencing in December 1994, the Company will be required to make annual cash payments to the trustee equivalent to 25% of the greatest aggregate principal amount of such series outstanding at any one time prior to a specified date, the cash payments must be applied to redeem bonds of the 11.58% series at 100% of the principal amount thereof. With respect to the 12.63% series, commencing in December 2001, the Company will be required to make annual cash payments to the trustee of a specified amount, the cash payments must be applied to redeem bonds of the 12.63% series at 100% of the principal amount thereof.

Second Mortgage Bonds have been issued to secure the three variable rate pollution control bond issues due 2014 and 2015, as well as the floating rate note issue due in 1991.

(3) The funds on deposit with a trustee at December 31, 1990 represent a portion of the proceeds from pollution control revenue bonds and accumulated related interest income, which are to be disbursed as needed to pay the cost of acquiring, constructing, reconstructing, improving, maintaining or furnishing the pollution control facilities financed.

(4) These bonds are supported by long-term irrevocable letters of credit issued by banks. (See Note L). The bonds bear interest at various rates (6.2% to 6.5% during 1990) which will cause the bonds to have a market value which approximates, as nearly as possible, their par value. The bonds may be required to be repurchased at the holder's option and are subject to mandatory

redemption upon the occurrence of certain events and are redeemable at the option of the Company under certain circumstances.

(5) In February 1991, the note, which had a LIBOR interest rate of 10.08%, was redeemed.

(6) The unsecured note due 1992 is floating rate, 8.56% at December 31, 1990.

(7) In December 1986, the Company entered into a financing obligation related to one sale and leaseback transaction involving Palo Verde Unit 2. (See Note E). Semiannual payments, including interest (using an assumed interest rate of 9.01%), which began in July 1987, are $4,181,000, with the last payment of $2,091,000 due in July 2013.

(8) In 1980 the Company leased a turbine and certain other related equipment from the trust-lessor for a twenty-year period, with renewal options for up to seven more years. Semiannual lease payments, including interest, which began in January 1982, are $719,000 through January 1991, and $861,000 thereafter to July 2000. The effective annual interest rate implicit in this lease is calculated to be 9.6%. A gain to the Company related to the sale of the turbine to the trust in the amount of $2,343,000 is being amortized to income over the term of the lease.

(9) The Company enters into lease arrangements with an independent trust with respect to nuclear fuel loadings into Units 1, 2 and 3 at Palo Verde Station. The Company accounts for the leases as capital leases and, accordingly, has recorded obligations which have balances of $24,769,000 for Unit 1, $21,135,000 for Unit 2 and $21,018,000 for Unit 3 at December 31, 1990 (interest rate of 9.54% at December 31, 1990). Quarterly lease payments made are based on units of heat production.

Scheduled maturities of long-term and financing and capital lease obligations and sinking fund requirements at December 31, 1990 are as follows (in thousands):

1991	$116,704
1992	62,288
1993	20,929
1994	47,722
1995	36,934

Nuclear fuel is fully replaced in the units approximately every three years at which time the related capital lease obligation is recorded. The table above includes scheduled maturities, within that three-year cycle, of obligations existing at December 31, 1990 and does not reflect future fuel loadings and related obligations and maturities.

K. Federal Income Taxes

The detail of federal income taxes by component is as follows:

	Years Ended December 31,		
	1990	1989	1988
		(In thousands)	
Current income taxes:			
Operating	$ 959	$(20,206)	$ 2,736
Other income	92	1,350	1,137
Total	1,051	(18,856)	3,873
Deferred income taxes:			
Operating	(3,201)	40,393	7,335
Other income:			
Regulatory disallowance	(12,456)	(6,051)	—
Other	2,753	732	8,176
Total	(12,904)	35,074	15,511
Charge (benefit) equivalent to investment tax credit:			
Operating	1,666	(15,389)	1,351
Other income	—	1,972	—
Total	1,666	(13,417)	1,351
Amortization of investment tax credit:			
Operating	(4,957)	(3,267)	(2,774)
Other income	—	—	—
Total	(4,957)	(3,267)	(2,774)
Total federal income tax expense (benefit)	$(15,144)	$ (466)	$17,961

Federal income tax provisions differ from amounts computed by applying the statutory rate of 34% to book income from continuing operations before federal income taxes. Detail is as follows:

	Years Ended December 31,		
	1990	1989	1988
		(In thousands)	
Tax computed at statutory rate	$(12,583)	$ 506	$ 27,825
(Decreases) increases due to:			
Allowance for equity funds used during construction	(1,650)	(4,276)	(4,442)
Amortization of equity funds used during construction	1,670	3,126	1,258
Dividends received not subject to federal income tax	—	(716)	(2,333)
ITC amortization	(4,957)	(3,267)	(2,774)
Amortization of excess deferred taxes	(3,878)	(1,297)	(722)
Investment valuation adjustment	—	2,380	—
Provision for other taxes	—	3,881	—
Adjustment for over-reversal of liberalized depreciation	2,112	—	—
Adjustment to deferred tax provision	2,536	—	—
Other	1,606	(803)	(851)
Total federal income tax expense (benefit)	$(15,144)	$ (466)	$ 17,961
Effective federal income tax rate	(40.92)%	(31.33)%	21.95%

The provisions (credits) for deferred federal income taxes, which arise from the timing differences between financial and tax reporting are as follows:

	Years Ended December 31,		
	1990	1989	1988
		(In thousands)	
Tax effect of:			
Operating income:			
Depreciation differences	$ 11,507	$17,554	$11,834
Deferred fuel revenues	1,094	3,819	1,318
Provisions for rate refunds	137	1,306	4,733
Allowance for borrowed funds	2,857	5,537	2,535
Taxes capitalized	287	480	1,126
Nuclear fuel expense differences	(2,537)	2,243	2,882
Deferred and capitalized Palo Verde operation and maintenance expenses	8,687	8,279	6,326
Sale and leaseback transactions	2,939	2,760	2,641
Deferred revenues	3,049	3,058	6,278
Alternative minimum tax deferred	—	1,066	(3,168)
Prudency audit costs	36	2,845	371
Offset of deferred tax credits due to tax net operating losses	(30,664)	—	(27,681)
Capitalized construction interest	(4,829)	(2,208)	—
Other	4,236	(6,346)	(1,860)
Other income:			
Regulatory disallowance (includes deferred tax credits offset due to tax NOL	(12,456)	(6,051)	—
Return on deferred costs	625	1,772	3,955
Investment income	3,026	(6,511)	959
Offset of deferred tax credits due to tax net operating losses	1,893	—	527
Other	(2,791)	5,471	2,735
Total deferred taxes	$(12,904)	$35,074	$15,511

The Company has a 1990 tax net operating loss of $88,180,000 based upon its tentative federal income tax return filed January 1991. Of this tax loss, $7,640,000 was carried back to 1987. The remaining $80,540,000 of the tax net operating loss is to be carried forward. The Company also has a tax net operating loss carryforward of $57,409,000 from 1988. These loss carryforwards expire in the years 2005 and 2003, respectively. For financial statement purposes, net deferred tax credits aggregating approximately $50,232,000 have been eliminated as of December 31, 1990 based upon their expected amortization during the carryforward periods. Upon realization of the tax benefits of the net operating loss carryforwards in subsequent periods, the amounts eliminated from deferred tax credits will be reinstated.

The Company incurred a capital loss in January 1990 as a result of the disposition of its stock in Franklin and PasoTex. Under provisions of federal income tax law, this capital loss must be used to offset capital gains generated in 1987. This carryback generated tax benefits of approximately $17,065,000 consisting of a cash refund of approximately $6,557,000 and a free-up of investment tax credits of approximately $10,508,000.

As a result of the carryback of the tax operating and capital losses generated in 1989 and 1990, the Company has freed up and has available for carryforward investment tax credits of approximately $21,450,000. In 1990, the Company generated $5,600,000 of investment tax credits from property qualifying under the Tax Reform Act of 1986 transition rules. The total investment tax credit carryforward at December 31, 1990 is approximately $27,050,000. Of this amount, approximately $11,600,000 will expire in 2001, approximately $9,850,000 will expire in 2002, and the remainder will expire in 2005.

At December 31, 1989, the cumulative net amount of income tax timing differences on which deferred income taxes have not been provided approximated $11,500,000.

The years 1979 through 1989 are considered to be open years by the IRS. The consolidated federal income tax returns of the Company for the years 1986 through 1989 are currently under examination by the IRS and there are issues currently pending upon administrative appeals with the IRS from 1983 through 1985. The Company believes that adequate provisions have been made through December 31, 1990 for additional tax that may be due, if any.

L. Commitments and Contingencies

Construction commitments for the Company subsequent to December 31, 1990, total approximately $59,904,000, which includes AFUDC (net of related deferred tax) in the amount of $4,152,000.

The Company has a nuclear fuel purchase contract with an independent trust which is not reflected in the Company's balance sheets. The amount of such commitment at December 31, 1990 was $14,800,000. The Company has elected and intends to continue to elect to purchase the heat produced from the fuel in the trust as the basis for payment for fuel loadings. To finance its obligations, the trust has a credit agreement providing for borrowings up to $125,000,000 of which $91,900,000 was drawn at December 31, 1990. The borrowing facilities under the credit agreement are supported by a bank letter of credit in the amount of $125,000,000. The credit agreement will terminate January 8, 1993 unless the credit bank rescinds its notice of termination prior to that date and the trust consents to such rescission. Absent rescission of the notice of termination, the Company will be required to refinance or retire by January 8, 1993 the trust obligations. The Company is, under the purchase contract with the trust, required to pay the trust upon termination of the purchase contract, an amount equal to the net investment of the trust in nuclear fuel plus an amount, if any, necessary for the trust to pay in full amounts owing on the trust's revolving line of credit.

The Company had letters of credit outstanding at December 31, 1990 of approximately $213 million in support of certain debt arrangements (see Note J) and $300 million in support of certain lease arrangements (see Notes C and E).

First Service Life Litigation

Pending Actions Involving the Company's Collateral. On September 26, 1988, the Company filed a declaratory judgment action in the 345th Judicial District Court, Travis County, Texas, against First Service Life Insurance Company, life insurance company organized under the laws of the Cayman Islands ("First Service"), and R. B. Ashworth, as Conservator for the affairs of First Service under the Texas Insurance Code for a determination that (i) the Company has legal, valid, duly perfected and enforceable security interests in certain collateral (the "Collateral") granted to the Company by First Service to secure payment of certain annuities purchased by the Company from First Service, the present balance of which is approximately $20 million; and, (ii) that events of default have occurred under the collateral security documents pertaining to these annuities, which entitle the Company to enforce its security interests. On May 27, 1988, the Company notified First Service that First Service was in default under the annuities and the collateral agreements and that the Company intended to enforce its security interests. The Conservator, who was appointed by the Texas Commissioner of Insurance in early June, 1988, notified the Company that First Service might not be in default, expressed doubt as to the validity and enforceability of the security interests held by the Company and demanded the Company return to the Conservator all of the Collateral and desist and refrain from proceeding with enforcement and any other interference with the conservatorship and the conservatorship proceedings.

On September 29, 1988 the Conservator, in conjunction with his answer and denial of the Company's declaratory judgment action, countersued the Company on behalf of First Service, and two affiliated corporations, First Service Life, a Turks & Caicos Corporation ("FSL") and Knickerbocker Life Insurance Company ("Knickerbocker"), for actual damages of at least $50 million, plus punitive damages of at least $300 million. The Conservator's counterclaim seeks (i) a temporary and permanent injunction against the Company's enforcement of its security interests in the Collateral, (ii) an accounting from the Company as to all payments on and transfers of property to the Company from First Service with respect to the Company's annuity investment, (iii) a declaratory judgment that the Company's security interests are illegal and unenforceable under the Texas Insurance Code, and that the sale and purchase of the annuities was an illegal transaction under the Texas Insurance Code by a company doing business in Texas without authorization; and, (iv) disgorgement by the Company of all payments on its annuities and all collateral therefor. The counterclaim alleges several causes of action against the Company including principally fraud, conversion and breach of duty of good faith and fair dealing (based upon an alleged affiliate or "insider" relationship between the Company and First Service).

On December 1, 1988, a receiver (the "Receiver") was appointed for First Service, and on December 13, 1988, the Receiver in his capacity for First Service was substituted as a party for the Conservator. The Company then filed a Plea in Intervention to the Receivership Proceedings to protect the interest of the Company. On January 18, 1989, the Receiver was appointed as receiver for FSL as well. On May 5, 1989, the Receiver was appointed as receiver for Knickerbocker. On July 6, 1989, the Receiver, in his capacity as receiver for Knickerbocker only, non-suited without prejudice his claims against the Company.

On February 16, 1990, the Receiver joined as parties defendant Maury Page Kemp, Jean Kemp, the accounting firm of Coopers & Lybrand, and the law firm of Kemp, Smith, Duncan & Hammond, which serves as general counsel to the Company.

Although only preliminary discovery has been conducted, the Company's legal counsel, Small, Craig & Werkenthin, P.C., Austin, Texas, has reviewed the basic facts of the case with the Company's management and other parties familiar with various aspects of the transactions involved in the litigation, examined documents and records of the Company and other parties which relate to such transactions, and evaluated the allegations against the Company made in the counterclaim. Based upon its preliminary evaluation and investigation of the case to date, and subject to the results of discovery, counsel believes that it is more likely than not that the outcome of the litigation will be favorable to the Company.

The Company believes that the Company's security interests in the collateral are valid and enforceable, and the Company intends to recover amounts owed to it on the annuities through enforcement of its rights to the collateral. The Company strongly denies the allegations of the counterclaim, believes the counterclaim is without merit and intends to vigorously defend against it. At June 30, 1989, the Company recorded a provision for loss of $7 million based upon the value of the collateral. The Company has made no provision for loss for the effects, if any, of the ultimate outcome of the litigation.

Claims by Annuitants. On October 16, 1989, the case of *Pedro Meneses, et al. v. Maury Page Kemp, et al.*, Civil Action No. EP-89-CA-374, was filed in the Western District of Texas, El Paso Division. That action was dismissed in May of 1990 without prejudice to refiling.

On May 16, 1990, Beatrice Meneses, and certain other parties filed their Plea in Intervention in *Pedro Meneses v. First Financial Savings Association of El Paso*, et al. in the County Court of El Paso, Texas, Cause No. 88-9254. The parties and allegations made in this case are substantially similar to the case previously filed and dismissed in the Western District of Texas. Essentially, the case was dismissed from federal court and refiled in state court to obtain a different forum. The plaintiffs are allegedly holders of annuities purchased from First Service and/or Knickerbocker and/or Security Southwest Life Insurance Company (the "Annuitants"). The defendants include the beneficial principal shareholders and officers and directors of First Service and Knickerbocker, certain affiliated companies of the principal beneficial shareholders of First Service and Knickerbocker, the Company, its former subsidiaries, PasoTex and Franklin, the accounting firm of Coopers & Lybrand, the law firm of Kemp, Smith, Duncan & Hammond, which serves as general counsel to the Company, and two individual attorneys who are shareholders in such firm, one Tad R. Smith, formerly a director of the Company.

The Company and other defendants removed the case to the United States District Court for the Western District of Texas, El Paso Division, on June 11, 1990, Civil Action No. EP-90-CA-247H (hereinafter referred to as the "RICO Action"). The RICO Action alleges that the defendants violated the Racketeer Influenced and Corrupt Organizations Act ("RICO"), conspired to violate RICO, violated federal and Texas securities laws, committed common law fraud, civil conspiracy to defraud, and asserts violations of the Texas Deceptive Trade Practices Act, the Texas Insurance Code and the Texas Penal Code. The claims made against the Company and its former subsidiaries are based upon allegations that the Company controlled and/or conspired with First Service. The Plaintiffs are seeking damages in the amount of their lost annuities, plus interest, multiplication of actual damages, punitive and exemplary damages, and attorneys' fees and costs. The complaint in the RICO Action alleges sales of annuities to the Plaintiffs in a value in excess of $11 million, and makes a claim for unspecified punitive damages and attorneys' fees.

The Company vigorously denies any liability in respect of the RICO Action and believes that all related claims are without merit. No formal discovery has been conducted by any of the parties to the RICO Action. Based upon the limited evaluation and investigation of Small, Craig & Werkenthin, P.C., Austin, Texas, the Company's legal counsel in connection with the pending litigation, such counsel believes that it is more likely than not that the ultimate outcome of the RICO Action will be favorable to the Company. The Company has made no provision for loss for the effects, if any, of the ultimate outcome of the litigation.

The RICO Action names as a defendant Billye E. Bostic, formerly an executive officer of the Company, who would be entitled to indemnity under the Company's charter, bylaws and other applicable agreements to the same extent as indemnification is afforded by the Company to all of its officers and directors with respect to service on boards of directors of other companies. However, whether Mr. Bostic will be entitled to such indemnity from the Company with regard to the RICO Action has not yet been determined and such determination will be dependent on all the facts and circumstances which may surface during the course of this litigation. Mr. Bostic has advised the Company that he denies any liability in respect of the RICO Action and believes that the claims asserted against him therein are without merit. Mr. Bostic is represented by counsel separate from the Company's counsel. While the Company is currently assuming Mr. Bostic's legal expenses, no provision for an indemnity payment, if any, is included in the 1990 financial statements.

Suit Against Directors of First Service. On February 3, 1989, the Receiver filed suit in the 345th Judicial District Court, Travis County, Texas, against certain individuals who were alleged to be directors of First Service and/or FSL, including Mr. Bostic.

The Receiver alleges that First Service engaged in the sale of annuities in Texas without authorization to do so and that such actions constituted illegal insurance transactions under the Texas Insurance Code. The Receiver further alleges that the alleged illegal sale of annuities by First Service constitutes a breach by the directors of First Service of their fiduciary duty to exercise due care in the management of the affairs of First Service and/or FSL and resulted in unspecified losses to First Service. The suit seeks actual damages of at least $33 million and, in addition, exemplary damages of at least double the actual damages. No significant discovery has been conducted at this time.

Mr. Bostic has advised the Company that he denies that he served as a director of First Service or FSL during the period of the alleged activities complained of, denies any liability in respect of the Receiver's suit and intends to vigorously defend against it. Mr. Bostic is represented by counsel separate from the Company's counsel in the First Service litigation. Mr. Bostic would be entitled to indemnity with respect to the Receiver's suit to the extent indemnification is afforded by the Company to all of its officers and directors with respect to service on certain outside boards. However, whether Mr. Bostic will be entitled to such indemnity from the Company with regard to this lawsuit has not yet been determined and such determination will be dependent on all the facts and circumstances which may surface during the course of this litigation.

Because no significant discovery has been conducted, counsel for Mr. Bostic is unable to express an opinion as to the ultimate outcome of the suit. While the Company is currently assuming Mr. Bostic's legal expenses, no provision for an indemnity payment, if any, is included in the 1990 financial statements.

Settlement negotiations have been conducted and are ongoing with a view toward a settlement which would terminate all of the above described First Service Life litigation as it relates to the Company. No formal settlement arrangement has been entered into and, at this time, the Company is unable to determine whether a settlement can be achieved or what the terms of any such settlement would be.

There are numerous parties who purchased annuities from First Service, not included as parties to these lawsuits, who may assert additional claims, similar in nature to the claims asserted by the current parties against the Company. These claims, if asserted, could result in additional suits against the Company.

P&C Lacelaw Trust Litigation

On September 26, 1990, P & C Lacelaw Trust ("Lacelaw") filed suit in the 346th District Court of El Paso County, Texas against the Company, Franklin, a former subsidiary of the Company, and DDG, Inc. ("DDG"), the party which purchased all of the capital stock of Franklin from the Company in January 1990. Lacelaw alleges that Franklin acted in bad faith and participated in self-dealing in connection with Franklin's management, as general partner, of a limited partnership between Franklin and Lacelaw, the purpose of which was to acquire, own and operate an office building in downtown El Paso. Lacelaw further alleges that the Company is responsible for the actions of Franklin because Franklin was the alter ego of the Company and that the Company breached fiduciary duties to Lacelaw in connection with the mismanagement and self-dealing by Franklin and through the sale of Franklin to DDG. Lacelaw seeks a declaratory judgment that the Company is a general partner in the partnership; a judgment declaring Lacelaw's rights as a limited partner; an accounting of all financial transactions involving the partnership; and a dissolution of the partnership. Lacelaw alleges actual damages of $3,200,000 and punitive damages of at least $10,000,000. The Company vigorously denies any liability with respect to this lawsuit and believes that the claims are without merit. Investigation and evaluation of the suit by counsel for the Company is in its preliminary stages and only a minimal amount of discovery has been concluded; therefore, the outcome of the suit cannot be determined at this time.

Palo Verde Liability and Insurance Matters

The Palo Verde participants have insurance for public liability payments resulting from nuclear energy hazards to the full limit of liability under federal law. This potential liability is covered by primary liability insurance provided by commercial insurance carriers in the amount of $200 million and the balance by an industry-wide retrospective assessment program. The maximum assessment per reactor under the retrospective assessment program for each nuclear incident is approximately $66 million, subject to an annual limit of $10 million per incident. Based upon the Company's 15.8% interest in the three Palo Verde units, the Company's maximum potential assessment per incident is approximately $31.3 million, with an annual payment limitation of $4.74 million. The insureds under this liability insurance include the Palo Verde participants and "any other person or organization with respect to his legal responsibility for damage caused by the nuclear energy hazard."

The Palo Verde participants maintain "all risk" (including nuclear hazards) insurance for property damage to, and decontamination of, property at Palo Verde in the aggregate amount of $2.325 billion, a substantial portion of which must first be applied to decontamination. The Company has also secured insurance against portions of any increased cost of generation or purchased power resulting from the accidental outage of any of the three units if the outage exceeds 21 weeks.

Arizona Tax Matters

Arizona Sales Tax. In 1986 and 1987, the Company entered into sale and leaseback transactions with respect to its interest in Unit 2 and 40% of Unit 3 at the PVNGS. Pursuant to the leases in such transactions (the "Palo Verde Leases"), the Company is obligated to hold the lessors harmless against certain tax events. Following a recent audit by the Arizona Department of Revenue (the "ADR"), the Company was advised in September 1990 by a staff member of the ADR that the taxability of the payments under such leases could change if certain interpretations are adopted by the ADR. Currently, 8% of the property subject to the Palo Verde Leases is considered real property, and sales tax has been paid on that portion of the lease payment for all lease payments made after July 1988. The ADR may contend that (1) either all, or some portion above 8%, of the property subject to leases is real property and that sales tax was due on lease payments beginning in 1987 and/or (2) the property taxes paid on behalf of the lessors constitutes income subject to Arizona sales tax. If the ADR proposes interpretation (1) and prevails, the Company would, in the worst case, owe approximately $15.6 million in back taxes through 1990, and annual lease expenses would increase by $4.6 million for 1991 and thereafter. If the ADR proposes interpretation (2) and prevails, the Company would owe back taxes of approximately $1.3 million through 1990 and would experience increased lease expense of $.6 million annually thereafter (assuming that 100% of the lease payment is taxable). The Company has not officially been notified by the ADR that such interpretations would be sought, and it is uncertain whether these or any other interpretations will be assessed by the ADR. The Company believes it has meritorious defenses to the claims described, but no assurance can be given that the Company will prevail against such claims. The Company would seek to recover any increased expenses through rates.

Arizona Income Tax. By Notice of Proposed Correction of Income Tax dated February 9, 1990 ("Notice"), the ADR, in connection with an audit examination of the taxable years 1984 through 1987, informed the Company that the ADR has determined that the gains from the 1986 and 1987 sales of the Company's interest in Palo Verde Unit 2 and a portion of the Company's interest in Unit 3 are allocable to Arizona for state income tax purposes on the grounds that the units constitute non-business assets with a situs in Arizona, resulting, according to the ADR, in a proposed deficiency assessment, including related interest and penalties, of approximately $39.5 million ($42.5 million if interest is extended through December 31, 1990), exclusive of any net operating loss ("NOL") carryforwards. On March 28, 1990, the Company filed a protest to the proposed deficiency assessment. The Company believes Palo Verde Units 2 and 3 constituted business assets at the time of the respective sales, and, in accordance with Arizona law, it apportioned, rather than allocated, the corresponding gains in paying the Arizona income tax on the transactions.

A formal administrative hearing with the Hearing Office of the ADR was held on October 19, 1990, at which time the Hearing Officer allowed the ADR, over the Company's objections, to raise issues not contained in the ADR's Notice. The two primary issues so raised by the ADR are: (1) whether the Company properly excluded from the Arizona sales factor computation in 1986 and 1987 the gross proceeds from the sale and leaseback transactions involving Palo Verde Units 2 and 3, respectively; and (2) whether carryovers of Arizona NOL generated in the taxable years 1979 through 1983 can be used by the Company to offset Arizona taxable income in the taxable years 1984 through 1987. The Company does not expect that the Hearing Office will issue an order reflecting its decision on the case issues until mid to late summer 1991. The Company will appeal to the Director of the ADR any adverse determination by the Hearing Office, and will litigate any issues not satisfactorily resolved through the administrative review process. The Company does not expect to incur any material liability in respect of the proposed determination of the ADR.

Preferred Stock Tax Indemnity

In July 1989, the two corporations which are the beneficial owners of the Company's 11.375% preferred stock, aggregate par value $50 million, notified the Company that the IRS had proposed to disallow those holders the dividends received deduction taken by them on their 1985 income tax returns with respect to the dividends they received on that stock. At the same time the IRS also made the same proposed disallowance to the beneficial owners of a number of preferred stock issues of other utilities. Under an agreement the Company entered into on issuance of the shares in 1984, the Company has agreed to indemnify the beneficial owners for loss of the dividends received deduction by reason of IRS action. The beneficial owners are contesting the proposed disallowance as required by the agreement.

In January 1990, the beneficial owners provided the Company a schedule of indemnity payments that would be due if the IRS were to prevail. By the owners' calculation, an indemnity payment of $28,637,989 for additional taxes, penalties and interest to September 30, 1989 ($31,362,852 if interest is extended to December 31, 1990) would be due for all dividends paid from January 1, 1985, through October 1, 1989, and additional indemnity payments with respect to dividends due thereafter, paid as the quarterly dividends are paid, would total $6,848,697. Under the indemnity agreement, the owners can require the Company to escrow, during the pendency of the IRS contest, the indemnity payments that would be owing if the IRS prevails, because the Company's First Mortgage Bonds are not rated at specified levels. To date the owners have not required an escrow. The escrow, if established, would be invested for the account of the Company.

Under the Company's interpretation of the indemnity agreement, it requires the Company to make indemnity payments, assuming the IRS prevails, only for dividends paid after the Company received, in July 1989, notice of the proposed IRS action, and therefore, if any escrow is required, the Company would be obligated to escrow indemnity payments only for the October 1, 1989 dividend and each quarterly dividend thereafter as it is paid. If the Company's interpretation is sustained, then, depending on how a dispute is resolved on the tax rate to be used in determining the indemnity payments, the indemnity payment or earlier escrow deposit would be $795,985, by the Company's calculation, or $1,304,826, by the owners' calculation, for the additional tax, penalty and interest to December 31, 1990, with respect to the October 1989 dividend. For the dividends paid thereafter, the indemnity payment or escrow deposit for each dividend would decrease as the preferred stock is redeemed according to its terms ($10 million a year from July 1990, to final redemption in July 1994), and would total, over the 42-month period, $6,422,136 by the Company's calculation, or $6,848,698 by the owners' calculation. Counsel to the Company believes that the beneficial owners are more likely to prevail than the IRS on the proposed disallowance of the dividends received deduction, and also believes that, if the IRS does prevail, there is substantial support for the Company's position that it is not obligated to indemnify for past dividends. If the IRS were to prevail, the Company believes its dividend and indemnity payments would be deductible as interest paid for federal income tax purposes.

Since these indemnity payments, even under the Company's interpretation, would increase the Company's pre-tax cost by more than 50 basis points, the indemnity agreement gives the Company the right to redeem all of the shares for par plus any indemnity payments due, at any time through the third dividend payment after conclusion of the IRS contest. The Company's present intention, which may change, is not to seek repurchase of the shares before conclusion of the tax contest.

Regardless of the resolution of this matter, the Company was liable for indemnity payments to the owners for additional taxes due by reason of the reduction in the dividends received deduction by the Tax Reform Act of 1986 and the Revenue Act of 1987. On June 5, 1990, the Company paid the owners a one-time indemnity payment of $1.5 million to satisfy the Company's obligations to the owners in regard to the indemnity pursuant to the Tax Reform Act of 1986 and the Revenue Act of 1987. This satisfaction of the indemnity obligation reduces the indemnity due if the IRS prevails on its proposed total disallowance of the dividends received deduction.

In September 1989, the IRS sought technical advice on the tax issues from its National Office in Washington, D.C., using the case of the preferred stock issued by another public utility as a "test case," but a year later the IRS withdrew its request for technical advice. Recently, the IRS changed its approach in its test case, dropping the proposed disallowance of the owners' dividend received deduction and substituting, in its stead a proposed disallowance of the deduction the owners claimed for interest on the notes they issued to finance the purchase of the preferred stock, on the grounds that the leveraged purchase lacked economic substance, an elimination of the owners' dividend income that does not exceed the owners' interest expense, and a reclassification of the owners' dividend income over interest expense as taxable income not qualifying for a dividend received deduction. In March 1991, the IRS submitted its new approach to its National Office for technical advice. A change of the IRS position in its "test case" does not necessarily mean the IRS will or can assert a similar position in the case of the owners of the Company's preferred stock. The Company's indemnity agreement does include an agreement to indemnify against additional taxes due to loss of the deduction for the interest expense, but only with respect to interest paid after the owners have notified the Company that the IRS has disallowed the deduction.

M. Pension Plans and Other Postretirement Benefits

The Company's Retirement Income Plan for Employees of El Paso Electric Company (the "Plan") covers employees who have completed one year of service with the Company and are 21 years of age. The Plan is a noncontributory defined benefit plan. Upon retirement or death of a vested plan participant, assets of the Plan are used to pay benefit obligations under the Plan. Contributions from the Company are based on the minimum funding amounts required by the IRS under provisions of the Plan, as actuarially calculated. The assets of the Plan consist primarily of fixed income instruments.

The Company's Supplemental Retirement and Survivor Income Plan for Key Employees (SERP) is a non-qualified, non-funded pension plan which covers certain key employees of the Company. The pension cost for the SERP is based on substantially the same actuarial methods and economic assumptions as those used for the defined benefit plan.

Net periodic pension cost under SFAS No. 87, *Employers Accounting for Pensions*, is made up of the components listed below as determined using the projected unit credit actuarial cost method. Prior to 1989, the Company's net periodic cost was determined using the aggregate actuarial cost method.

Net periodic pension cost for these plans for 1990, 1989 and 1988 (in thousands):

	December 31,		
	1990	1989	1988
Service cost for benefits earned during the period	$ 1,641	$ 1,361	$ 1,249
Interest cost on projected benefit obligation	3,882	3,811	3,138
Actual return on plan assets	314	(3,422)	(1,597)
Net amortization and deferral	(2,324)	1,550	(205)
Net periodic pension cost	3,513	3,300	2,585
Amount (capitalized) expensed due to actions of the regulator	(561)	(7,504)	—
Net periodic cost recognized	$ 2,952	$(4,204)	$ 2,585

The assumed annual discount rates used in determining the net periodic pension cost were 7.75%, 8.25% and 8.75% for 1990, 1989 and 1988, respectively.

The pension cost includes amortization of unrecognized transition obligations over a fifteen-year period beginning in 1987.

The funded status of the plans and amount recognized in the Company's balance sheets at December 31, 1990 and 1989 are presented below (in thousands):

	December 31,			
	1990		1989	
	Retirement Income Plan	SERP	Retirement Income Plan	SERP
Actuarial present value of benefit obligations:				
Vested benefit obligation	$(33,929)	$(6,335)	$(32,079)	$(5,938)
Accumulated benefit obligation	$(35,310)	$(6,412)	$(33,305)	$(6,041)
Projected benefit obligation	$(44,059)	$(8,040)	$(44,523)	$(7,354)
Plan assets at fair value	31,457	—	32,129	—
Projected benefit obligation in excess of plan assets	(12,602)	(8,040)	(12,394)	(7,354)
Unrecognized net loss from past experience	1,728	3,435	1,947	3,356
Unrecognized prior service cost	1,088	(125)	—	(258)
Unrecognized transition obligation	4,490	552	4,899	603
Adjustment required to recognize minimum liability	—	(2,234)	—	(2,388)
Accrued pension liability	$ (5,296)	$(6,412)	$ (5,548)	$(6,041)

During 1989, in connection with the Company's general workforce reduction a retirement window plan was established for participants in the Retirement Income Plan and SERP. The window plan resulted in net losses of approximately $5,512,000 and $1,992,000 for the Retirement Income Plan and SERP, respectively. The net losses have been deferred for recovery in rates.

Actuarial assumptions used in determining the actuarial present value of projected benefit obligation are as follows:

	1990	1989
Discount rate	8.00%	7.75%
Rate of increase in compensation levels	6.00%	7.00%
Expected long-term rate of return on plan assets	8.50%	8.00%

The Company provides certain health care benefits for retired employees and their eligible dependents and life insurance benefits for retired employees only. Substantially all of the Company's employees may become eligible for those benefits if they reach retirement age while working for the Company. The cost of retiree health care benefits is recognized as expense as claims are paid and the cost of providing retiree insurance benefits is recognized as expense as premiums are paid. For 1990 and 1989 health care costs were $437,000 and $701,000, respectively. Prior to 1989 the cost for retiree health care is not separable from the cost of providing those benefits for active employees. Also, the cost for retiree life insurance benefits is not separable from the cost of providing those benefits for active employees.

N. Franchises and Significant Customer

Franchises

The Company's major franchises are with the cities of El Paso, Texas and Las Cruces, New Mexico. Such franchises expire in 2001 and 1993, respectively, and do not contain renewal provisions. The Company believes, but has no assurance, that both franchises will be renewed. In July 1989, the City of Las Cruces began a review of possible alternatives to renewal of the Company's franchise and in February 1990 engaged outside consultants to assist in the review. On February 11, 1991, the consultants issued a feasibility report dealing with certain alternatives, including municipalization and acquisition of the Company's distribution system through a negotiated sale or condemnation. The report is under review by both the City of Las Cruces and the Company. The Company believes that the franchise will be renewed, perhaps on renegotiated terms. However, the outcome of the City's review of its alternatives and the ultimate impact on renewal of the franchise cannot be determined at this time. Las Cruces represents approximately 8% of the Company's operating revenues.

Significant Customer

In 1990, 1989 and 1988, IID, a wholesale customer, accounted for approximately $44,542,000, $49,584,000 and $43,395,000 or 10.3%, 11.6% and 11.4%, respectively, of operating revenue.

O. Selected Quarterly Financial Data (Unaudited)

	1990 Quarters				1989 Quarters			
	1st	2nd	3rd	4th	1st	2nd	3rd	4th
	(In thousands of dollars except for per share data)							
Operating revenues	$105,236	$109,677	$118,981	$ 98,607	$95,286	$109,331	$118,711	$102,920
Operating income	7,460	10,830	20,260	6,249	13,593	13,268	22,180	7,510
Net income (loss)	579	(4,417)	(5,525)	(12,501)	(5,720)	(30,038) (1)	(21,875) (1)	(48,200) (1)
Net loss applicable to common stock	(2,255)	(8,751)	(7,954)	(14,785)	(8,759)	(33,063)	(24,776)	(51,047)
Net loss per share of common stock	(0.06)	(0.25)	(0.23)	(0.42)	(0.25)	(0.94)	(0.70)	(1.46)

(1) The decline in net income during the last three quarters of 1989 was primarily due to the Company's decision to discontinue its remaining non-utility operations. The Company made provisions for the expected losses on the sale, including provisions for expected operating losses during the phase-out period. In December 1989 and January 1990, the Company sold all of its non-utility operations. (See Note P).

P. Discontinued Operations

During 1989, the Company decided to discontinue all of the non-utility operations conducted through the Company's principal subsidiaries, Franklin and PasoTex. Franklin had primarily been engaged in real estate operations in downtown El Paso and other investment activities. PasoTex had engaged through subsidiaries in a variety of non-utility activities, including specialty steel manufacturing, oil country tubular goods end-finishing and marketing, and furniture and accessory manufacturing.

The decision to discontinue these operations reflects the Company's plan to return its operations exclusively to its core utility business. That plan and the timing and nature of the dispositions of the non-utility operations and investments were impacted by a number of factors, including the cash requirements of such operations, regulatory, contractual and financing restrictions applicable to the Company, the value and future prospects for the discontinued operations, the timing and amount of federal income tax benefits associated with the disposition of the operations and the impact of the discontinued operations on the consolidated financial results of the Company.

In late December 1989, PasoTex sold its $60 million preferred stock investment in Commercial Federal Savings and Loan Association, Omaha, Nebraska. The Commercial Federal investment, which was written off by the Company in its entirety, net of tax benefits of $18,560,000, in the 1989 third and fourth quarters due to Commercial Federal's failure to meet regulatory capital requirements and continue paying dividends, was sold by PasoTex to an independent third party corporation, whose principals are experienced in the thrift industry, for a nominal amount of cash plus a $2 million non-recourse purchase money note. All principal and interest on the purchase money note is due on November 30, 1994, but mandatory prepayments are required based upon a percentage of the purchaser's net cash flow. The preferred stock was pledged to secure the payment of the purchase money note and is held by an independent escrow agent. As additional consideration in the transaction, PasoTex received a warrant to purchase 49.5% of the then outstanding shares of common stock of the third party purchaser (although shares purchased would be non-voting) for an aggregate consideration of approximately $500,000. The warrant may be exercised from time to time, in whole or in part, until December 30, 1996. The warrant may be assigned, subject to applicable securities laws. The transaction was supported by a fairness opinion from an investment banking firm retained by PasoTex. The note and warrant received by PasoTex in the sale were transferred to the Company prior to the sale of PasoTex and Franklin in January 1990.

Also in late December 1989, PasoTex surrendered its 50% common equity interest in Westwood Lighting Group, Inc., a lamp manufacturer, back to Westwood without consideration.

The disposition of the Commercial Federal preferred stock and the surrender of the Westwood common stock resulted in current federal income tax benefits of approximately $19 million and $2.6 million, respectively.

On January 17, 1990, the Company sold all of the capital stock of Franklin and its 35% stock ownership of PasoTex (which was owned 65% by Franklin) to an unrelated third party special purpose corporation, whose managers have substantial experience in the ownership and operations of diverse business enterprises. The Company received as consideration in the transaction the note and warrant received by PasoTex in the disposition of the Commercial Federal investment. The Company transferred at closing of the transaction approximately $3 million to PasoTex for working capital purposes and transferred approximately $5 million to Franklin on September 17, 1990, to be applied against the obligations of Franklin under its mortgage debt relating to a hotel owned in El Paso. As a result of the sale of Franklin, the Company's indirect liability for Franklin's $9,756,000 borrowings under the Rio Grande Resources Trust became a direct liability of the Company. The stock purchase agreement relating to the transaction provides for an indemnity payment, estimated at approximately $900,000, from the Company to the purchaser to compensate for certain federal income tax investment tax credit recapture liability which may be incurred upon Franklin's eventual sale of the hotel. The indemnity payment is contingent upon certain tax elections which the purchaser is entitled to make with respect to the sale of Franklin and PasoTex. The consideration for the transaction was based upon the combined values of Franklin and PasoTex. The transaction was supported by a fairness opinion from the Company's financial advisor, a nationally recognized investment banking firm.

The loss on the sale of Franklin and PasoTex generated federal income tax benefits of approximately $17 million. (See Note K.)

Operating results of discontinued operations have been reclassified from amounts previously reported and have been reported separately in the income statements. Revenues of discontinued operations were $250,602,000 and $268,635,000 in 1989 and 1988, respectively.

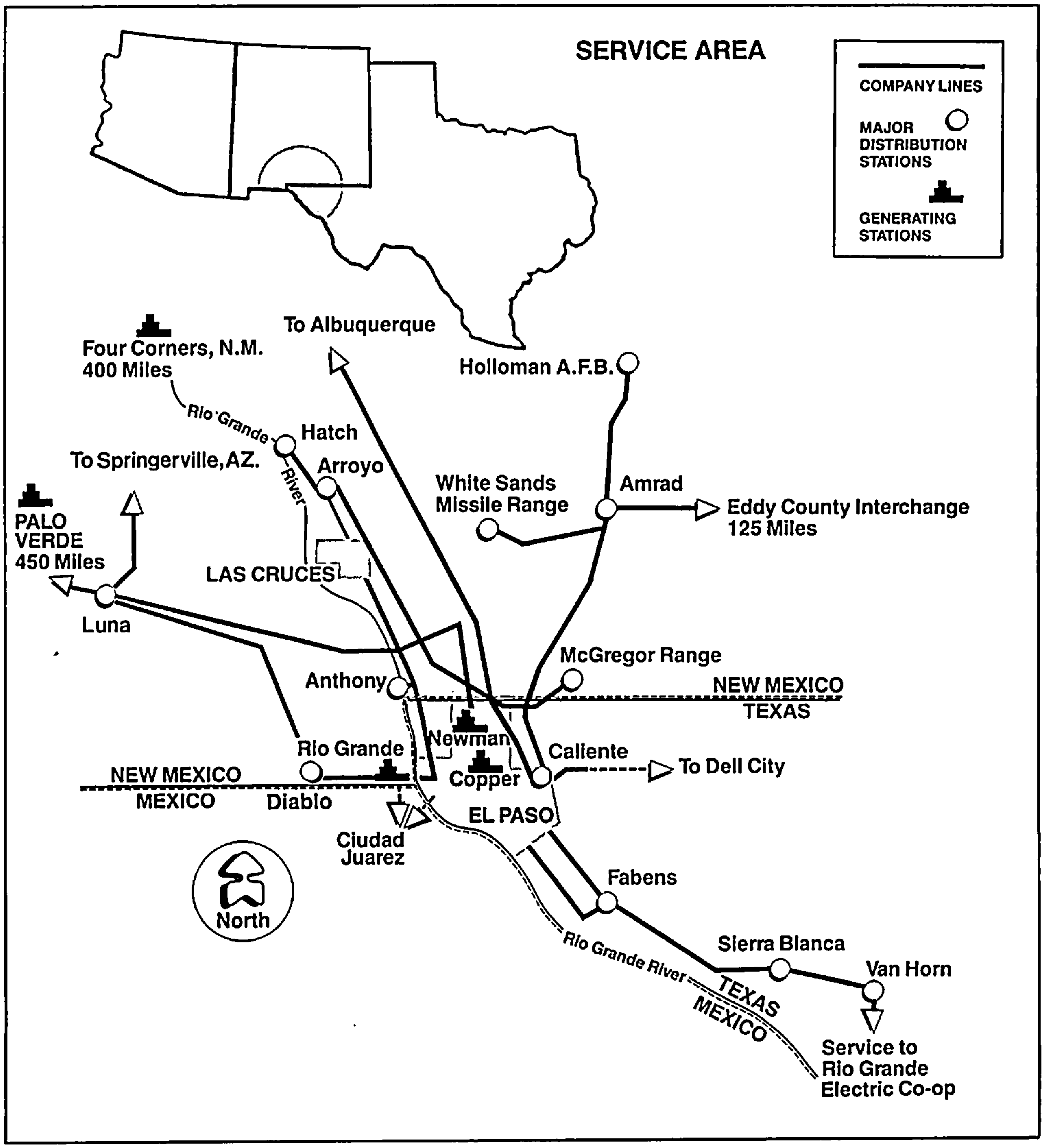
Interest paid on borrowed money related to discontinued operations was approximately $16,162,000 and $14,240,000, for the years ended December 31, 1989 and 1988, respectively.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

PART III and PART IV

The information set forth in Part III and Part IV has been omitted from this Annual Report to Shareholders.


SERVICE AREA
COMPANY LINES
MAJOR DISTRIBUTION STATIONS
GENERATING STATIONS
To Albuquerque
Four Corners, N.M.
400 Miles
Holloman A.F.B.
Rio Grande River
Hatch
Arroyo
To Springerville, AZ.
White Sands
Missile Range
Amrad
Eddy County Interchange
125 Miles
PALO
VERDE
450 Miles
LAS CRUCES
Luna
McGregor Range
Anthony
NEW MEXICO
TEXAS
Newman
Rio Grande
Caliente
To Dell City
NEW MEXICO
MEXICO
Copper
Diablo
EL PASO
Ciudad
Juarez
North
Fabens
Sierra Blanca
Van Horn
Rio Grande River
TEXAS
MEXICO
Service to
Rio Grande
Electric Co-op

El Paso Electric Company
P.O. Box 982
El Paso, Texas 79960

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The Electric Company
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