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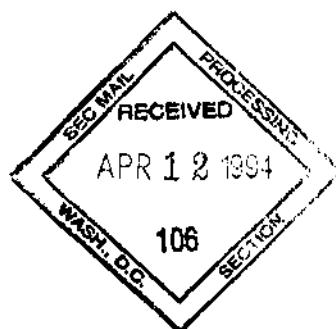
1993

ANNUAL REPORT

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DISCLOSURE INC.

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El Paso Electric Co.

ANNUAL MEETING OF SHAREHOLDERS

The annual meeting of El Paso Electric Co. will be held in the Sixth Floor Conference Room of the Company's offices located at the Centre Building, 123 Pioneer Plaza, El Paso, Texas, 79901, on Monday, May 23, 1994, at 10 a.m., El Paso time. In connection with this meeting, proxies will be solicited by the Board of Directors of the Company. A notice of the meeting, together with a proxy statement, a form of proxy and the Annual Report to Shareholders for 1993, were mailed on or about April 12, 1994, to shareholders of record as of March 25, 1994.

FELLOW SHAREHOLDERS:

March 31, 1994

As most of you are aware, on December 8, 1993, the U.S. Bankruptcy Court for the Western District of Texas entered an order confirming El Paso Electric's (EPE) plan of reorganization. The plan, if approved by regulators, would allow EPE to emerge from bankruptcy as a wholly-owned subsidiary of Central and South West Corporation (CSW), a public utility holding company based in Dallas, Texas. The plan was confirmed following an overwhelming vote by all of EPE's creditor groups and shareholders. In fact, of those common shareholders voting, 98 percent of the shares were voted in favor of the plan.

Confirmation of our plan of reorganization paves the way for EPE to emerge from bankruptcy in a healthy financial position. Throughout this process, our goal has been — and continues to be — to secure a viable solution that is fair and equitable for EPE's creditors, shareholders, and customers. Our plan of reorganization and acquisition by CSW will accomplish that goal.

On the effective date of the merger, EPE common shareholders will receive CSW common stock in exchange for their EPE shares according to a formula that valued EPE common stock at \$3.00 per share on the confirmation date of the plan of reorganization (approximately one-tenth of a CSW common share for every outstanding EPE common share). Additional consideration to EPE common shareholders (in the form of CSW common shares having a value of up to \$1.50 per share of EPE common stock) may be realized through the resolution of certain matters and the sale of certain non-

utility assets. In connection with the additional consideration that may be achieved, in recent weeks EPE has received approval from the Bankruptcy Court to sell the assets of Triangle Electric Supply Co., which will result in the realization of approximately \$10 million for EPE's common shareholders. The Company hopes it will complete the sale by the end of April 1994.

The Company also has filed a similar request for approval from the Bankruptcy Court for the settlement of federal income tax claims of the IRS, which will result in the realization of additional consideration having value of approximately \$27.8 million for EPE common shareholders under the provisions of the merger agreement. Assuming these values are realized, they will be added to the previously realized \$2.3 million and up to \$13.8 million that will be credited immediately prior to the effective date of the merger. Thus, EPE will achieve the maximum additional consideration amount provided in the merger agreement. Value also will be added for EPE common shareholders based on the dividends paid on CSW common stock between the confirmation date of the plan of reorganization and the effective date of the merger.

Even with Bankruptcy Court confirmation and creditor and shareholder support, however, the merger cannot be accomplished and realized until approvals are obtained from various state and federal regulatory agencies, including the Public Utility Commission of Texas, the New Mexico Public Utility Commission, the Securities and Exchange Commission, the Department of Energy, the Federal Energy Regulatory

Commission, and the Nuclear Regulatory Commission, among others. Thus, we anticipate the effective date of the merger will be sometime between 18 and 24 months from the confirmation date.

Toward that end, on January 10, EPE filed for a \$41.4 million (or 15 percent) base rate increase in its Texas jurisdiction. Because EPE's current rates are not sufficient to cover the cost of providing electric service to our customers, a rate increase is necessary for EPE to reorganize and become financially viable. However, CSW has offered our Texas customers a settlement proposal that would nullify nearly all the initial effects of EPE's \$41.4 million rate request. The settlement seeks a lower \$25 million base rate increase from Texas customers, offset by about \$13 million in fuel savings and a one-time \$16.4 million fuel refund to be credited to customers over 12 months. This means bills for EPE's Texas customers would increase only about 2 to 3 percent in the first year of the merger.

There has been much local publicity about the so-called "high rates" of El Paso Electric. However, it is important to put our rates in the proper perspective as they affect the Company's business, and the cost of living and commerce in our service territory. The fact is the average electric bill for Texas residential customers is about \$52 per month. This is among the lowest average electric bill of any major city in Texas. It also is in the lowest one-third percentile of average bills in the nation. Further, an average household electric bill in our service area represents only 2.3 percent of median household income. This is lower than most other areas of Texas and below the national average.

Merging El Paso Electric into the Central and South West operating

system will yield economies of scale that will benefit our customers — rate increases will be stabilized and substantially lower than if El Paso Electric had remained an independent stand-alone company. These efficiencies will help lower the

El Paso Electric is an attractive acquisition candidate because our service territory and total number of customers continue to grow, while other areas throughout the southwest and the country are experiencing limited growth in electricity sales.

WE
FINALLY
HAVE IDENTIFIED
AND
ARE MOVING
TOWARD A
VIABLE SOLUTION,
AND
THE POTENTIAL
BENEFITS
TO OUR
SHAREHOLDERS,
CREDITORS
AND
CUSTOMERS
ARE SIGNIFICANT.

The Company once again achieved record peak demands in 1993, recording an all-time total system peak demand of 1,335 megawatts (MW) on August 11, which was a 2.5 percent increase over the prior record peak of 1,302 MW in 1992. EPE's 1993 native peak demand of 997 MW also was a new record, increasing 2.4 percent from a peak of 974 MW in 1992. In addition, native system sales and total system sales increased 1.8 and 2.9 percent, respectively, over the previous year, and our total number of customers increased 2.8 percent. Looking ahead, we continue to expect steady electrical and economic growth in the communities we serve.

Further, the recent approval of the North American Free Trade Agreement should enhance continued growth in our service territory, and provide the opportunity for increased sales into the Republic of Mexico. This is yet another reason that Central and South West negotiated a merger agreement with EPE. Not only does our Company offer a solid, growing service territory, but it provides CSW with increased transmission access to the western U.S. and Mexico.

El Paso Electric currently has a contract with Mexico through 1996 to provide up to 150 megawatts of firm power sales to Mexico's rapidly growing northern border area. These sales continue, and our relationship with Mexico and its representatives is excellent. Central and South West also has a long-standing relationship with Mexico. In fact, in late-1993, CSW announced the opening of new

Company's operating and maintenance costs. And, perhaps more importantly, the merger will guarantee that electric service will continue to be reliable for all customers in El Paso Electric's service territory for many years to come.

offices located in Mexico City to foster an already strong relationship with that country's government and industry, and to pursue further electrical sales into Mexico.

In an effort to posture our company better in anticipation of its merger into the Central and South West system, the Company reduced its number of senior managers in early-1994. These personnel reductions allowed EPE to reduce layers of management and to begin aligning itself more closely with CSW in anticipation of the completion and implementation of the merger.

In addition, the Company and CSW have implemented a transition process. We will emphasize external and internal communications to address and accommodate concerns of employees and shareholders more effectively, and to foster improved relations and acceptance by our community leaders, citizens and customers. This process will be spearheaded by Curtis L. Hoskins. Curt has been the Company's chief operating officer since May 1990 and was elected president in January of this year. Curt's work, leadership and assistance to me has been invaluable over the past four years, and his experience with utility mergers will continue to be extremely important as we go forward to complete this process.

Eduardo A. Rodriguez also was promoted to senior vice president and general counsel. Eddie's oversight and leadership of the legal facets of the bankruptcy and merger processes have been — and continue to be — instrumental in achieving a very successful solution.

In summary, while this past year has been difficult, it also has been punctuated by success. When it was clear that EPE could not emerge from bankruptcy as a stand-alone com-

pany, the next alternative was to identify a strong, viable and highly-respected entity to negotiate a business combination or merger. Our merger into the Central and South West system will have positive, lasting effects on each constituency that EPE serves.

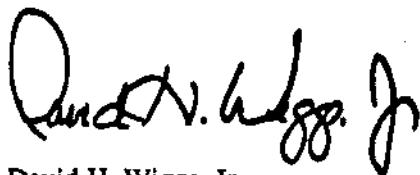
We finally have identified and are moving toward a viable solution, and the potential benefits to our shareholders, creditors and customers are significant. Yet, we still face the complex and demanding challenges of obtaining regulatory approvals during this transition period. Rest assured that all of us at EPE remain fully dedicated to completing this merger in a timely and efficient manner.

Finally, in closing, I particularly want to thank our employees, who continue to perform at exceptional levels during a very difficult period of time. They are the strength of our Company, and I congratulate them on their ability to stay focused and to continue providing superior customer service and administrative support. I also want to thank each member of EPE's Board of Directors for their strong leadership, and for their tremendous commitment of time, energy and resources in getting this process accomplished. Thus, I encourage you to vote your proxy for the three EPE Board members who are currently slated for re-election. Finally, and most significantly, I wish to thank you — our shareholders — for your continued support of EPE's Board, senior management and employees.

One final note — this letter to shareholders presents only an overview. For a comprehensive discussion of our plan and the merger agreement with CSW, I encourage you to read the detailed discussion of these and other important issues facing our Company contained in the attached

Annual Report on Form 10-K. We will, of course, keep you informed of future developments.

Sincerely,



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

BOARD OF DIRECTORS

David H. Wiggs, Jr. (6)
Chairman of the Board
and Chief Executive Officer

Wilfred E. Binns (11)
President and Sole Shareholder,
Binns Construction & Realty, Inc.,
Las Cruces, New Mexico

Sidney G. Baucom (2)
Of Counsel, Jones, Waldo, Holbrook
& McDonough, Salt Lake City, Utah

Wilson K. Cadman (1)
Retired in 1992. Prior to retirement,
Chairman of the Board, President and
Chief Executive Officer, Kansas Gas
& Electric Co., Wichita, Kansas

James A. Cardwell (4)
President and Principal Shareholder,
Cardwell Properties, Inc., El Paso,
Texas (multi-business holding and
investment company)

George W. Edwards, Jr. (1)
President and Chief Executive
Officer, Kansas City Southern
Railway Co., Kansas City, Missouri

Curtis L. Hoskins (4)
President & Chief Operating Officer

Josefina A. Salas-Porras (15)
Educator, El Paso, Texas
(consultant in second language and
multi-cultural training)

Thomas C. Simpson (11)
President and Principal Shareholder,
Simpson Farms, Inc., Las Cruces,
N.M.

COMPANY OFFICERS

David H. Wiggs, Jr. (6)
Chairman of the Board
and Chief Executive Officer

Curtis L. Hoskins (4)
President & Chief Operating Officer

Eduardo A. Rodriguez (12)
Senior Vice President
and General Counsel

Julius F. Bates, Jr. (22)
Vice President-Customer Services

John E. Droubay (4)
Vice President and Treasurer

Russell G. Gibson (4)
Controller
and Chief Accounting Officer

Gary R. Hedrick (16)
Vice President-Financial Planning
and Rate Administration

John C. Horne (21)
Vice President-
Transmission Systems Division

James A. Mayhew (14)
Vice President-
Rates and Energy Utilization

Robert C. McNeil (16)
Vice President-
New Mexico Division

Guillermo Silva, Jr. (15)
Secretary

() Years of Service

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 Relations Dept.,
Bank of New York
Church Street Station
P.O. Box 11258
New York, New York 10286-1258.

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.

Or call: 1-800-592-1634 or
1-800-351-1621.

SECURITIES AND RECORDS

The common stock of El Paso Electric Company is traded and quoted on the NASDAQ Stock Market. The ticker symbol for the common stock is ELPAQ. ("Q" indicates Company is operating under Chapter 11 of the United States Bankruptcy Code.)

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.

FORM 10-K REPORT

A complete copy of El Paso Electric's Annual Report on Form 10-K for the year ended December 31, 1993, which has been 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:

The Office of the Secretary
El Paso Electric Company
Post Office Box 982
El Paso, Texas 79960.

Form 10-K
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

(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, 1993
- 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)

74-0807870
(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 NO _____.

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of
Regulation S-K is not contained herein, and will not be contained, to the best of registrant's
knowledge, in definitive proxy or information statements incorporated by reference in
Part III of this Form 10-K or any amendment to this Form 10-K. [X]

As of March 1, 1994, the aggregate market value of the voting stock held by non-affiliates
of the registrant was \$93,173,349.

As of March 1, 1994, there were outstanding 35,544,330 shares of common stock, no par
value.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement for the 1994 annual meeting of its
shareholders are incorporated by reference into Part III of this report.

DEFINITIONS

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

<u>Abbreviations, Acronyms or Defined Terms</u>	<u>Terms</u>
ADR	Arizona Department of Revenue
AFUDC	Allowance for Funds Used During Construction
AIP	Arizona Interconnection Project
ANPP Participation Agreement	Arizona Nuclear Power Project Participation Agreement dated August 23, 1973, as amended
APB	Accounting Principles Board
APS	Arizona Public Service Company
Bankruptcy Case	The case commenced January 8, 1992 by El Paso Electric Company in the Bankruptcy Court as Case No. 92-10148-FM
Bankruptcy Court	United States Bankruptcy Court for the Western District of Texas, Austin Division
Bankruptcy Code	United States Bankruptcy Code, 11 U. S. C. §101 et seq.
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
Confirmation Date	December 8, 1993; the date the Plan was confirmed by the Bankruptcy Court
CSW	Central and South West Corporation
CSW Sub	A wholly-owned special purpose subsidiary of CSW to be formed in connection with the transactions contemplated by the Merger Agreement
CWIP	Construction Work in Progress
Disclosure Statement	Disclosure Statement related to Modified Third Amended Plan of Reorganization
DOE	United States Department of Energy
DOJ	United States Department of Justice
EPA	United States Environmental Protection Agency
Effective Date	The date the Plan becomes effective
EPE	El Paso Electric Company
FERC	Federal Energy Regulatory Commission
FPA	Federal Power Act
Four Corners	Four Corners Project or Four Corners Plant
Franklin or Franklin Land	Franklin Land & Resources, Inc., a former subsidiary of the Company
FTC	Federal Trade Commission
HSR Act	Hart-Scott Rodino Antitrust Improvements Act of 1976
IID	Imperial Irrigation District, an irrigation district in Southern California
IRS	Internal Revenue Service
KV	Kilovolt(s)
KW	Kilowatt(s)
KWH	Kilowatt-hour(s)
LIBOR	The rate of interest, per annum, equal to the London Interbank Offered Rate (90-day LIBOR for 1994 is assumed to be 3.5%)
Merger Agreement	Agreement and Plan of Merger dated as of May 3, 1993 among the Company, CSW and CSW Sub, as amended

<u>Abbreviations, Acronyms or Defined Terms</u>	<u>Terms</u>
MW	Megawatt(s)
MWH	Megawatt-hour(s)
NASD	National Association of Securities Dealers, Inc.
NASDAQ	National Association of Securities Dealers Automated Quotation System
Navajo Nation	Navajo Nation of Indians
New Mexico Commission or NMPUC	New Mexico Public Utility Commission
NMED	New Mexico Environment Department
NOL	Net Operating Loss
NRC	Nuclear Regulatory Commission
Owner Participants	The entities that participate as equity investors in the trusts that, through the Owner Trustee, purchased and leased back portions of the Company's interests in Palo Verde Units 2 and 3
Owner Trustee	The First National Bank of Boston, which acted as purchaser and lessor under the sale and leaseback transactions involving Palo Verde Units 2 and 3, in its capacity as trustee for the trusts established for the benefit of the Equity Participants
Palo Verde Participants	Those utilities who share in power and energy entitlements, and bear certain allocated costs, with respect to PVNGS pursuant to the ANPP Participation Agreement
Palo Verde Station or Palo Verde Project or Palo Verde or PVNGS	Palo Verde Nuclear Generating Station
Plan	Modified Third Amended Plan of Reorganization
PNM	Public Service Company of New Mexico
PUHCA	Public Utility Holding Company Act of 1935
RCF	Revolving Credit Facility pursuant to the 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
Reorganized EPE	El Paso Electric Company after completion of its reorganization in bankruptcy
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SPS	Southwestern Public Service Company
TEP	Tucson Electric Power Company
Texas Commission	Public Utility Commission of Texas
Texas District Court	State District Court of Travis County, Texas
TNP	Texas-New Mexico Power Company
TNRCC	Texas Natural Resources Conservation Commission, successor to the Texas Air Control Board and the Texas Water Commission

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PART I

Item 1. Business

Introduction

The Company was incorporated in Texas in 1901. Its business is the generation and distribution of electricity through an interconnected system to approximately 262,000 customers in El Paso, Texas, and an area of the Rio Grande Valley in West Texas and Southern New Mexico, and to wholesale customers located in such diverse locations as Southern California and Mexico. The Company had approximately 1,140 employees as of December 31, 1993, approximately 29% of which are covered by a collective bargaining agreement that expires in February 1995. The Company's principal 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 784,000, including approximately 631,000 people in the metropolitan area of El Paso. Copper smelting and refining, oil refining, garment manufacturing, cattle raising and agriculture are significant industries in El Paso, which is also an important transportation and distribution center. Historically, the Company's major franchises have been with the cities of El Paso, Texas, and Las Cruces, New Mexico. The franchise with the City of El Paso expires in March 2001 and does not contain renewal provisions. The Company's 25-year franchise with the City of Las Cruces expired in March 1993 and the Company and the City entered into a one-year franchise agreement while negotiations for a long-term agreement continued. The one-year franchise expired March 18, 1994, and the parties continue to negotiate. For a discussion of the status of the Company's major franchises and major customers, including the potential loss of certain of such franchises and customers, see Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations — Operational Challenges."

Bankruptcy Proceedings for Reorganization of the Company Filing

On January 8, 1992, the Company filed a voluntary petition for reorganization under Chapter 11 of the Bankruptcy Code in the Bankruptcy Court. The filing followed an attempt by the Company during 1991 to negotiate a restructuring of its obligations with its creditors and the draws in late December 1991 on letters of credit related to the Company's sale and leasebacks of portions of its interest in Palo Verde. The Company's management has continued to manage the operations and affairs of the Company, subject to the authority of the Company's Board of Directors, as debtor in possession. Certain actions of the Company during the pendency of the bankruptcy proceedings, however, including, without limitation, transactions outside of the ordinary course of business, are subject to the approval of the Bankruptcy Court. In addition, with the execution of the Merger Agreement (described herein), certain actions may be prohibited or limited or the consent of or notice to CSW required.

Effect of Bankruptcy on Disclosures Contained Herein

The discussions and descriptions of Company events and the analysis of their potential impact on financial results herein are premised on the assumption that the Company's operations will be maintained within existing financial agreements, as modified by the Plan, and regulatory structures prior to the Effective Date of the Plan. This report must be read with the understanding that the Plan, which has been confirmed by the Bankruptcy Court, but has not become effective, will alter, compromise or modify the existing financial and regulatory structures if it becomes effective. Substantial conditions to the Plan becoming effective exist, as discussed herein, and the Company believes, but can give no assurance, that such conditions will be satisfied. It is possible that the Plan will not become effective. If the Plan does not become effective, another plan of reorganization also

would alter, compromise or modify existing financial and regulatory structures. See "Alternatives to the Plan," below. It is therefore not possible at this time to state with certainty the nature or degree to which the existing financial and regulatory structures will be altered, compromised or modified. Accordingly, estimates and evaluations based on the historical results of Company operations could be subject to material changes as a result of the eventual resolution of the Bankruptcy Case.

Modified Third Amended Plan of Reorganization

On September 8, 1992, the Company filed a plan of reorganization, which was amended subsequently, based on the Company remaining an independent company. On December 8, 1992, the Company began solicitation of the plan of reorganization, but suspended solicitation on December 23, 1992, following a ruling by the Bankruptcy Court in a pending adversary proceeding. See "Treatment of Palo Verde" below.

Concurrently with pursuing the initial plan of reorganization, the Company had engaged in an analysis of potential combinations with other companies in the event the stand-alone plan of reorganization could not be consummated. On May 3, 1993, the Company and CSW entered into the Merger Agreement, which provides for the Company to become a wholly-owned subsidiary of CSW. On May 5, 1993, the Company filed its Third Amended Plan of Reorganization and Third Amended Disclosure Statement in connection with the Merger Agreement, which was modified subsequently. The related disclosure statement was approved by the Bankruptcy Court by orders dated August 27, 1993, and September 15, 1993, and solicitation of the Plan began shortly thereafter. On November 15, 1993, voting on the Plan concluded, with at least 92% of those voting in each applicable class of creditors and interest holders voting in favor of the Plan.

Prior to the confirmation of the Plan, certain technical modifications to the Plan that did not require creditor or interest holder approval were made. On December 8, 1993, the Bankruptcy Court entered an order confirming the Plan. A description of the primary features of the Plan is set forth below.

Description of the Merger

The Plan proposes a reorganization of the Company pursuant to which the Company would become a wholly-owned subsidiary of CSW. Under the Plan, creditors and equity security holders of the Company would receive for their claims cash and/or securities of either the Company, as reorganized, and/or securities of CSW or would have their claims cured and reinstated pursuant to the Bankruptcy Code. Pursuant to the Merger Agreement, and effective simultaneously with the effectiveness of the Plan, CSW Sub would merge with and into the Company (the "Merger"), and CSW would become the owner of all of the issued and outstanding shares of common stock of the Company. The Company would continue to operate as a public utility company and would become a direct, wholly-owned, operating subsidiary of CSW. The Company's shareholders would receive consideration as described below. Secured creditors generally would receive value equal to 100% of their allowed claim. Small unsecured creditors also would receive 100% of their allowed claim and other unsecured creditors would receive 95.5% of the principal amount of their allowed claim and would receive interest on the 95.5% amount on a current basis through the Effective Date, as described more fully below.

CSW, a Delaware corporation, is a registered holding company under the PUCRA. CSW owns all of the outstanding shares of common stock of Central Power and Light Company ("CPL"), Public Service Company of Oklahoma ("PSO"), Southwestern Electric Power Company ("SWEPCO"), and West Texas Utilities Company ("WTU") (collectively, the "CSW Electric Operating Companies"), and has certain other subsidiaries and affiliates. The CSW Electric Operating Companies are public utility companies engaged in generating, purchasing, transmitting, distributing and selling electricity. CPL and WTU operate in portions of south and central west Texas, respectively; PSO

operates in portions of eastern and southwestern Oklahoma; and SWEPCO operates in portions of northeastern Texas, northwestern Louisiana and western Arkansas.

Certain conditions specified in the Plan and the Merger Agreement must be satisfied or waived prior to the Effective Date of the Plan for the Merger to be consummated and the Plan to become effective. A summary of such conditions is set forth below.

Conditions to Effectiveness of the Plan and Merger

The Merger will become effective upon the issuance of a certificate of merger by the Secretary of State of Texas or at such later time as may be provided in Articles of Merger that will be filed with the Secretary of State of Texas upon the satisfaction of all conditions to effectiveness of the Plan and Merger. The Merger Agreement and Plan contain numerous conditions to effectiveness, including but not limited to the following described conditions:

- (i) receipt of the regulatory approvals and determinations that, in the judgment of the Company and CSW, are reasonably required to implement the provisions of the Plan and consummate the Merger. Such regulatory approvals generally include approvals and/or determinations by the FERC, the SEC, the Texas Commission, the New Mexico Commission and the NRC, as well as a filing with both the FTC and DOJ pursuant to the HSR Act and the expiration or termination of the waiting period applicable to such filing;
- (ii) the absence of occurrences that result or could result in a material adverse effect on the Company or CSW;
- (iii) performance by the Company, CSW and CSW Sub of all covenants contained in the Merger Agreement; and
- (iv) receipt of an investment-grade rating for all publicly tradeable Reorganized EPE First Mortgage Bonds and Reorganized EPE Second Mortgage Bonds.

Other than certain regulatory or statutory approvals that may not be waived, CSW and the Company may waive all or any portion of any of the conditions to effectiveness of the Plan and Merger. A number of the conditions have already been satisfied or have had significant steps taken toward their satisfaction: the Plan was confirmed on December 8, 1993; settlements (that become effective on the Effective Date) were entered into on November 15, 1993 (and have been approved by the Bankruptcy Court) resolving the adversary proceeding between the Company and the Palo Verde Owner Participants and providing for the transfer back to the Company of title to the leased portions of Palo Verde on the Effective Date; a capital structure for the Company as of the Effective Date has been designed that the Company believes will meet the rating agencies' requirements for an investment-grade rating; and applications have been filed with the FERC, NRC, SEC, the Texas Commission and the New Mexico Commission, as discussed more fully in "Regulatory Aspects of the Plan and Merger," below. Nevertheless, the conditions to effectiveness are significant and there can be no assurance that all such conditions will be satisfied.

Regulatory Aspects of the Plan and Merger

Consummation of the Plan and Merger is conditioned on receipt of required regulatory approvals, including those discussed below. In addition, Section 1129(a)(6) of the Bankruptcy Code provides that a plan of reorganization may be confirmed only if any governmental regulatory commission with jurisdiction, after confirmation of the plan, over rates of the debtor has approved any rate change provided in the plan, or such rate change is expressly conditioned on such approval. The effectiveness of the Plan is expressly conditioned upon obtaining Texas and New Mexico orders, including rate orders, establishing certain ratemaking, accounting and regulatory treatments acceptable to CSW

unless this condition is waived by CSW and the Company. There is no anticipated change to rates charged FERC jurisdictional customers under the Plan. Under the Merger Agreement, CSW is given the right to designate lead counsel with respect to, and control all applications, notices, petitions and filings relating to, the regulatory approvals and determinations described herein that are conditions to the effectiveness of the Merger. The Merger Agreement provides that both CSW and the Company are required to use reasonable best efforts to secure such approvals and determinations. The Merger Agreement further provides that CSW must use reasonable efforts in controlling the applications, notices, petitions and filings to preserve the Company's ability to file independent rate proceedings with and seek rates from appropriate Texas regulatory authorities based upon the Company's own cost of service components (assuming the Merger is not consummated), in the event that the Company seeks rate relief in any independent proceeding not precluded by the Merger Agreement.

Proposed Texas Rate Treatment. The effectiveness of the Plan and the Merger is conditioned upon the receipt by the Company and CSW of the following Texas regulatory approvals and determinations unless such conditions are waived by CSW and the Company:

- (i) a final order of the Texas Commission satisfactory to CSW and the Company authorizing a base rate increase of \$25 million to be effective for the Company in 1994 and authorizing certain ratemaking, accounting and regulatory treatments of the assets, expenditures, costs and revenues of the Company;
- (ii) a final order of the Texas Commission satisfactory to CSW and the Company to the effect that the combination of the Company with CSW Sub contemplated under the Plan is in the public interest and authorizing certain regulatory treatments with respect to the combination; and
- (iii) a final order of the Texas Commission satisfactory to CSW and the Company to the effect that the repurchase by the Company of the previously leased Palo Verde Unit 2 and 3 assets and the ratemaking treatment for the repurchased assets as plant-in-service in rate base at the net depreciated original book cost are in the public interest.

Rate Filing. The Company filed on January 10, 1994, for its fifth increase under the terms of the Rate Moderation Plan ordered by the Texas Commission in Docket 7460, and a base rate increase under the inventory plan for Palo Verde Unit 3 established in Docket 9945. See "Business — Regulation — Texas Rate Matters," below. The proposed rate changes represent what the Company believes is supported under Texas law and prior Texas Commission orders, adjusted to reflect its proposed acquisition by CSW. The filing is proceeding under Docket 12700.

The total amount of the Company's requested cash base rate increase, exclusive of fuel, in the filing is approximately \$41.4 million. The total increase consists of (i) a base rate increase of \$8.3 million, constituting the proposed 3.5 percent increase contemplated under the Rate Moderation Plan for costs other than those associated with Palo Verde Unit 3; and (ii) a base rate increase of \$33.1 million, constituting the proposed increase under the inventory plan for Palo Verde Unit 3. As discussed below, CSW has made a contemporaneous settlement offer that proposes rates lower than those reflected in the Company's rate filing.

In the Docket 12700 proceeding, the Company has further proposed to reconcile its Texas fuel costs and revenues for the period from April 1989 through June 1993 and to decrease its current average fixed fuel factor. The proposed decrease in the average fixed fuel factor is anticipated to decrease annual fuel revenues by approximately \$14.3 million. As a result of the fuel reconciliation and treatment of other fuel-related items, the Company has accrued in its financial statements and proposes to refund to Texas jurisdictional customers (as a credit to fuel revenue collections) approximately \$16.4 million over a 12-month period. In addition, the Company proposes to recover from Texas jurisdictional customers over a 12-month period a rate case expense surcharge of

approximately \$8.7 million. The net effect of the proposed changes, together with the requested rate increases, would be an approximate \$19.4 million increase in revenues from Texas jurisdictional customers for the first 12-month period the changes are in effect.

The Company has not included in the rate filing a request to recover the costs of bankruptcy reorganization or the \$288.4 million from the draws on the letters of credit related to the Company's sale and leasebacks of portions of its interest in Palo Verde, which draws occurred in late December 1991 and early January 1992. The Company has sought to reserve the ability to seek recovery of such costs if the Plan does not become effective.

Texas Merger Application. In addition to the Company's rate filing, the Company and CSW filed on January 10, 1994, a Joint Report and Application (the "Texas Merger Application") with the Texas Commission requesting (i) a determination that the acquisition by CSW of one hundred percent of the Company's common stock is consistent with the public interest; and (ii) certain determinations regarding the regulatory treatment of the Company's proposed reacquisition of the portions of Palo Verde that it previously sold and leased back.

As part of the Texas Merger Application and as a basis of settlement, CSW proposes rates for Texas jurisdictional customers of the Company that are substantially less than those reflected in the Company's rate case filing. The CSW settlement offer is contingent on the determination by the Texas Commission that CSW's acquisition of the Company is consistent with the public interest and the other regulatory determinations and approvals requested in the Texas Merger Application. The proposed settlement offers (i) to limit the non-fuel base rate increase for Texas jurisdictional customers to \$25 million; (ii) a proposed \$12.8 million reduction in fixed fuel factors; (iii) a refund of \$16.4 million over a 12-month period of over-recovered fuel costs and other fuel-related items; and (iv) a rate case expense surcharge of \$4.1 million related to previous rate cases to be collected over a 12-month period. Taking into account the annual reduction in fuel costs and the proposed fuel refund, the Company's revenues from Texas jurisdictional customers would not increase during the first year after the rate change goes into effect. The settlement rate plan proposed by CSW also provides for (i) a freeze in the effectiveness of any additional base rate increase until 1997; (ii) a limitation in the frequency of base rate increases following the rate freeze period through 2001 to not more than once every other year (i.e., 1997, 1999 and 2001); and (iii) a limitation on the amount of the 1997, 1999 and 2001 base rate increases, such that each increase would not exceed eight percent of total revenues.

The Company expects the City of El Paso and some intervenors in Docket 12700 will contest both the Merger and the proposed rate increase. However, at this time, the City of El Paso has taken no official action in opposition to or support of the Merger or requested rate increase. The Company anticipates the number of intervenors will be greater than in a typical rate filing. SPS and other Texas utilities have filed motions to intervene. The Company cannot predict at this time whether the settlement proposal will be adopted by the Texas Commission as proposed or whether the Texas Commission will enter the requested findings in connection with the Texas Merger Application. The Texas Merger Application has been consolidated with Docket 12700. The presiding officers approved a stipulation under which hearings in the consolidated proceeding will begin in late July 1994. The Company will be entitled to increase its rates under bond in mid-July 1994, subject to refund depending on the final outcome of the proceeding. The Company has not determined what level of increase would be implemented under bond, should it choose to do so. The Company anticipates a final order will be issued in Docket 12700 during the first half of 1995.

Proposed New Mexico Rate Path. The effectiveness of the Merger Agreement and, therefore, the Plan and the Merger contemplated thereby are, unless waived by CSW and the Company, conditioned on the receipt by the Company and/or CSW of the following New Mexico regulatory approvals and determinations:

- (i) a final order of the NMPUC satisfactory to the Company and CSW approving the combination of the Company with CSW;
- (ii) a final order of the NMPUC satisfactory to the Company and CSW authorizing a base rate increase for the Company of \$6 million for the New Mexico jurisdiction to be effective as of January 1, 1995, as contemplated by the rate plan set forth in an exhibit to the Plan, and authorizing certain ratemaking, accounting and regulatory treatments of the assets, expenditures, costs and revenues of the Company;
- (iii) a final order of the NMPUC satisfactory to the Company and CSW authorizing the issuance by the Company of the securities required for the consummation of the Plan;
- (iv) a final determination by the NMPUC that none of the transactions between the Company and CSW contemplated by either the Plan or Merger Agreement involve a Class II transaction (which generally relate to certain investments or transactions with affiliates) or, if the NMPUC determines that a Class II transaction is involved, a satisfactory final order by the NMPUC approving a diversification plan relating to the combination of the Company with CSW and the transactions between the Company and other CSW subsidiaries which are conducted in the normal course of operations of the CSW System; and
- (v) a final determination by the NMPUC that the Company does not require a new CCN as a result of the transactions between the Company and CSW, as contemplated in either the Plan or Merger Agreement, or, if the NMPUC determines that a new CCN is required for the NMPUC, a satisfactory final order issuing a new CCN to the Company.

The Company and/or CSW, as appropriate, will file one or more joint applications seeking the regulatory approvals described above. The Company and CSW filed an application (the "New Mexico Merger Application") with the New Mexico Commission on March 14, 1994, which has been docketed as NMPUC Case No. 2575. The New Mexico Merger Application requests the New Mexico Commission, to the extent necessary and appropriate under the law, to approve (i) the acquisition by CSW of the outstanding common stock of the Company; (ii) the accounting treatment of the Merger; (iii) the reacquisition of portions of Palo Verde by the Company and the proposed accounting, regulatory and tax treatment associated with the reacquisition; and (iv) a General Diversification Plan for the Company for activities that will occur as a result of the Merger. Under New Mexico Commission rules, a General Diversification Plan is required for certain transactions among a public utility and its affiliates. As a result of the Merger, the Company would become affiliated with CSW and its subsidiaries and affiliates. The New Mexico Merger Application does not include any requests related to establishing different rates or related to the issuances of securities pursuant to the Plan; such requests will be included in separate applications. While the Company believes that the approvals and ratemaking, accounting and regulatory treatments being sought are in accordance with the relevant provisions of New Mexico law and the NMPUC's rules, no assurances can be given that the NMPUC will grant the approvals requested or make the determinations sought. While no assurances can be given, the Company believes that the necessary New Mexico regulatory proceedings can be completed within 18 months of filing the applications with the NMPUC.

NRC and Atomic Energy Act Issues. The Company holds NRC operating licenses in connection with its ownership interests in Palo Verde. The operating license authorizes the Company to be a participant in the facility. The Atomic Energy Act of 1954, as amended (the "Atomic Energy Act"), provides that such licenses or any rights thereunder may not be transferred or in any manner disposed of, directly or indirectly, to any person through transfer of control unless the NRC finds that such transfer is in accordance with the Atomic Energy Act and applicable NRC requirements and consents to the transfer. On January 13, 1994, APS, as Operating Agent for Palo Verde, joined by the Company, filed a request with the NRC (i) for consent to the indirect transfer of the Company's

possession and ownership interest in the Operating Licenses for Palo Verde Units 1, 2, and 3 that would occur as a result of the Merger; and (ii) to amend the Operating Licenses for Units 2 and 3 to delete provisions of those licenses related to the Company's sale and leaseback transactions involving those units. On March 2, 1994, the NRC published in the Federal Register its proposed determination that the January 13, 1994 request "involve[d] no significant hazards consideration." The NRC has proposed to determine that the requested amendment would not: (i) involve a significant increase in the probability or consequences of an accident previously evaluated; (ii) create the possibility of a new or different kind of accident from any previously evaluated; or (iii) involve a significant reduction in a margin of safety.

Pursuant to standard NRC practice, on March 14, 1994, the NRC requested public comment on the proposed transfer of control of ownership. In that Notice, the NRC also provided an opportunity for comment on "whether significant changes in the licensees' activities have occurred since the completion of the previous antitrust review." In that Notice, the NRC staff stated that "[t]he NRC will consider the FERC proceeding to the maximum extent possible in resolving issues [of competitive aspects] brought before the NRC." Pursuant to the NRC Notice, timely written comments have been requested to be submitted to the NRC within 30 days of the Notice.

The request to the NRC specifies that the requested amendments to the Operating Licenses and consent become effective on the Effective Date upon notification by the applicants that all necessary regulatory approvals have been obtained, but the Company cannot predict at this time whether and when the approvals and consent will be granted.

FERC and Federal Power Act Issues. Under the FPA, FERC regulates certain activities of "public utilities," which includes the Company. The FPA requires the Company to obtain FERC authority to sell, lease or otherwise dispose of its interstate transmission facilities, including a merger that vests control in another person. Also, FERC approval of other transactions contemplated under the Plan may be required including: (i) the issuance and sale by the Company of new securities; and (ii) the amendment of the CSW System Operating Agreement to include the Company as a party.

The Company and CSW are seeking use of the transmission system of SPS, an electric utility based in Amarillo, Texas, to coordinate the operations of the Company and the CSW Electric Operating Companies. The Company has requested that SPS agree to provide the transmission service and make the system modifications necessary to accomplish such coordination. On November 4, 1993, the Company and Central and South West Services, Inc. ("CSWS"), as agent for the CSW Electric Operating Companies, filed an application with the FERC under Sections 211 and 212 of the FPA seeking an order of the FERC directed to SPS and requiring SPS to provide firm and non-firm transmission services in connection with transfers of power between the control areas of PSO and the Company in connection with the post-merger coordinated operations of the Company and the CSW Electric Operating Companies, pursuant to the CSW System Operating Agreement. This transmission service is sought as one means to meet the requirement of the PUHCA that the electric utility operating subsidiaries of a registered holding company system be physically interconnected or capable of physical interconnection and under normal operating conditions be economically operated as a single interconnected and coordinated electric system. On December 22, 1993, SPS responded to the application and requested that the application be dismissed or, in the alternative, be set for hearing. In the December 22, 1993 response and subsequent pleadings, SPS argues that the requested transmission services (i) would adversely affect SPS's system reliability and harm it and its native customers, (ii) would be impermissibly anti-competitive and (iii) is beyond that which can be ordered under the FPA. SPS also claims the Company and the CSW Electric Operating Companies failed to make a good faith request for the transmission services as required by FERC regulations. The FPA provisions authorizing such transmission requests were added in the Energy Policy Act and, as a result, there is little precedent or guidance available with respect to their application.

On January 10, 1994, as supplemented January 13, 1994, the Company and CSWS, on behalf of the CSW Electric Operating Companies, filed a joint application with the FERC pursuant to Section 203 of the FPA requesting a determination by the FERC that the Merger and the resulting disposition by the Company of indirect control over its jurisdictional facilities, consisting of the Company's interstate transmission facilities, is consistent with the public interest. Twenty-nine parties have filed motions to intervene or protests in the Section 203 filing. The Company and CSWS have requested expedited consideration of the joint application, but the Company cannot predict at this time when the FERC will issue its decision on the Joint Application.

Under the FPA, the FERC will approve a merger if it finds it to be "consistent with the public interest." In making its public interest determination, the FERC typically applies six criteria: (i) whether the proposed merger will have an adverse effect on the rates and operating costs of the merging utilities and/or their surviving corporation; (ii) whether the merger will have a negative impact on competition; (iii) whether the proposed accounting treatment is consistent with FERC regulations; (iv) whether the purchase price is reasonable; (v) whether the acquiring utility has coerced the acquired utility into accepting the merger; and (vi) whether the proposed merger will impair effective regulation either by the FERC or the appropriate state and local regulatory authorities.

CSWS also filed with the FERC on January 10, 1994, for approval under Section 205 of the FPA, an agreement among the Company, CSWS and the CSW Electric Operating Companies to amend the CSW System Operating Agreement and to make the Company a party to the CSW System Operating Agreement.

No assurance can be given that the FERC will grant the required approvals under the FPA, when such approvals might be granted, or upon what terms or conditions such approvals might be given. It is a condition to the obligations of CSW, CSW Sub and the Company under the Merger Agreement that a FERC order approving the Merger not contain conditions substantially more onerous than those in recent FERC orders with respect to mergers involving electric utility companies.

SEC and PUHCA Issues. CSW is a public utility holding company as defined in the PUHCA and is registered under such Act. CSW is required to obtain the approval of the SEC prior to consummating the Merger. The SEC is directed to approve a proposed merger unless it finds that (i) the acquisition would tend toward interlocking relations or a concentration of control of public utility companies, of a kind or to an extent detrimental to the public interest or the interest of investors or consumers; (ii) the consideration to be paid in connection with the acquisition is not reasonable or does not bear a fair relation to the sums invested in or the earning capacity of the utility assets underlying the securities to be acquired; or (iii) the acquisition would unduly complicate the capital structure of the applicant's holding company system or would be detrimental to the public interest or the interest of investors or consumers or the proper functioning of such holding company system. To approve a proposed acquisition, the SEC must find that the acquisition would tend toward the economical and efficient development of an integrated public utility system and would otherwise conform to the PUHCA's integration and corporate simplification standards. The SEC also must find that all state laws that apply to the Merger have been satisfied, unless it determines that compliance with such state laws would be detrimental to the purposes of the PUHCA.

Under the PUHCA, the SEC must find that after the Merger the Company and CSW will constitute an integrated electric system. As noted, the Company and CSW propose to coordinate their operations by means of transmission service to be provided by SPS. In the past, the SEC has determined that integration may be effected by means of transmission rights on unaffiliated systems.

SEC approval under the PUHCA will also be required for certain proposed transactions relating to the Merger. SEC approval will be required for the formation of CSW Sub. In addition, SEC approval (unless an exception is granted) will be required in connection with (i) the issuance of CSW

common stock to the holders of the Company's common stock and certain creditors, and (ii) the issuance of Reorganized EPE's securities to holders of the Company's securities and certain creditors pursuant to the Plan.

CSW filed an Application-Declaration on Form U-1 (the "Application-Declaration") with the SEC on January 10, 1994 pursuant to the PUHCA to seek authorization (i) of the merger of CSW Sub with and into the Company and the acquisition of the Company by CSW through such merger; (ii) of the issuance of securities by the Company and CSW in connection with the Plan and Merger and certain related transactions; and (iii) to engage in certain hedging transactions, all as presented in the Application-Declaration.

CSW has notified the Company of its intention to request a no-action letter from the SEC with respect to the issuance of CSW common stock and Reorganized EPE preferred stock pursuant to the Plan without registration under the Securities Act of 1933, as amended, and related matters.

Other Regulatory Filings. Under the FPA and the Department of Energy Act, the DOE must authorize persons to transmit electric energy from the United States. The Company holds an authorization to transmit electric energy to CFE. Under the Plan, CSW would become the owner of the common stock of the Company. The DOE requires that notice of a succession of ownership be filed with the DOE. In general, this notice must be filed at least 30 days prior to the effective date of any succession in ownership. The Company intends to file a notice of succession in ownership with the DOE at the appropriate time.

The Company also must file a notice related to the Merger with the FTC and DOJ pursuant to the HSR Act. The applicable waiting period following such filing must have expired before the Effective Date without an adverse ruling or other action by the FTC and DOJ with respect to any anticompetitive effects of the Merger. The Company intends to file a notice pursuant to the HSR Act at the appropriate time.

Treatment of Palo Verde

Major aspects of the Plan include (i) the rejection of the Company's leases relating to Palo Verde (the "Palo Verde Leases"), which extend to the Company's entire interest in Palo Verde Unit 2, approximately 40% of the Company's interest in Palo Verde Unit 3 and approximately one-third of its interest in the Common Plant; (ii) the resolution of any and all claims relating to such leases by the agreement that an amount equal to \$700 million would be the allowed claim of holders of lease obligation bonds related to the Palo Verde Leases and pursuant to settlement agreements entered into between the Company, the Owner Trustee and each of the Owner Participants; (iii) reacquisition of the leased portions of Palo Verde by the Company; and (iv) the Company's assumption of the ANPP Participation Agreement and related agreements.

Adversary Proceeding. On September 9, 1992, the Company filed an adversary proceeding against the lessors and the indenture trustees for the lease obligation bonds. The Company sought a declaratory judgment that the Palo Verde Leases are leases of real property under the Bankruptcy Code and, therefore, (i) the Palo Verde Leases were rejected pursuant to the Bankruptcy Code, and (ii) the Company's liability for damages resulting from the rejection of the Palo Verde Leases would be limited to approximately \$273 million. In addition, the Company sought a declaratory judgment that its liability for lease rejection would be fully satisfied by the proceeds of \$288.4 million from draws on letters of credit provided by the Company in connection with the Palo Verde Leases.

The defendants in the adversary proceeding asserted other claims against the Company, including claims for prepetition rent, postpetition rent, and fees and expenses incurred in connection with the Bankruptcy Case. In addition, the indenture trustees alleged that if the Palo Verde Leases

are leases of real property under the Bankruptcy Code, then the purchasers of the lease obligation bonds were defrauded by the Company.

On December 15, 1992, the Bankruptcy Court granted partial summary judgment against the Company with respect to one issue on lease rejection damages, holding that the proceeds of the draws on the letters of credit do not satisfy or offset the maximum claim allowable in the event the Palo Verde Leases were determined to be real estate leases. Following the ruling, the Company suspended solicitation on its Second Amended Plan of Reorganization and intensified its examination of alternatives. The Company ultimately entered into the Merger Agreement with CSW on May 3, 1993. On May 26, 1993, the Bankruptcy Court vacated the order of December 15, 1992, which left all issues in the adversary proceeding open.

Treatment of Adversary Proceeding Under the Plan. The Plan sets forth a proposed resolution pursuant to which the holders of bonds issued by two funding corporations would have allowed claims of \$700 million and such claims would be discharged by the issuance of securities in an amount equal to 95.5% of the allowed claims. See "Treatment of Claims Under the Plan – Class 12 – Claims Related to Palo Verde Leases, Palo Verde Lease Obligation Bonds and Palo Verde Secured Lease Obligation Bonds," below. The members of Class 12(a) accepted such proposal by voting in favor of the Plan.

The Plan also proposes a settlement of the claims by and against the Owner Participants pursuant to settlement agreements. The Company has entered into a settlement agreement with each of the Owner Participants and the Owner Trustee, which were approved by the Bankruptcy Court, but such settlement agreements will not become effective unless and until the Plan becomes effective. Pursuant to the settlement agreements, the Owner Participants would retain the \$288.4 million of proceeds from draws on the letters of credit. The Company and the Owner Participants would execute mutual releases and the adversary proceeding would be dismissed with prejudice at the Effective Date. In addition, any interest of the Owner Participants in Palo Verde would be transferred to the Company at the Effective Date, so the Company would regain the ownership interest of the portions of Palo Verde that were the subject of the Company's sale/leaseback transactions. Certain obligations of the Company under the participation agreements in the sale/leaseback transactions, such as the indemnification provisions, would survive pursuant to the terms of the settlement agreements.

Implications for Adversary Proceeding if Plan Does Not Become Effective. As a result of the vote of the holders of Class 12(a) claims and the settlement agreements, the adversary proceeding would be resolved by entry of an order dismissing the proceeding with prejudice. There would be no rulings on the substantive issues in the proceeding. If the Plan does not become effective, no entry of the dismissal order would occur. The Company would be faced with the alternatives of pursuing the adversary proceeding or seeking some other resolution. If the Bankruptcy Court were to grant the Company's motion for summary judgment, then the Palo Verde Leases would be deemed to be true leases of real property under the Bankruptcy Code, and the leases would be deemed to have been rejected on September 8, 1992, and the Company's liability for lease rejection damages would be limited under the Bankruptcy Code to three years of the rent reserved under the leases. The Company contends that this statutory amount is \$273 million. Such amount would be offset by the \$288.4 million proceeds from the draws on the letters of credit if the Bankruptcy Court ruled in the Company's favor. The defendants in the adversary proceeding contend that the statutory amount should include other Palo Verde expenses, but they have not disclosed an amount thereof. The defendants also contend that rejection of the leases would breach other contractual provisions and warranties and give them the right to recover additional damages that are not subject to the statutory limit. The amount of such alleged damages has not been specified, but the indenture trustees assert that total damages may exceed the outstanding amount of lease obligation bonds (\$698 million in principal plus accrued interest).

If the Bankruptcy Court were to find that the Palo Verde Leases are true leases of personal property under the Bankruptcy Code, then the leases would not be deemed to have been rejected on

September 8, 1992. The Company could nevertheless seek to reject the leases pursuant to the Bankruptcy Code, in which case the lessors could claim damages as provided in the leases. If the Bankruptcy Court were to find that the Palo Verde Leases are not true leases under the Bankruptcy Code, then the leases could not be rejected, and the indenture trustees may contend that the lease obligation bonds should be treated as direct obligations of the Company. The Company cannot quantify the monetary consequences to the Company under any of these scenarios.

ANPP Participation Agreement. The Company currently intends to assume the ANPP Participation Agreement and other agreements related to the operation of Palo Verde and has entered into a Cure and Assumption Agreement with the other Palo Verde Participants that was approved by the Bankruptcy Court on November 19, 1993. Pursuant to the agreement, the ANPP Participation Agreement and other operating agreements related to Palo Verde would be assumed by the Company effective on the Effective Date. See "Facilities – Palo Verde Station – ANPP Participation Agreement," below.

Treatment of Claims Under the Plan

The following is a description of each class of creditors and interest holders and a summary of the treatment of such class under the Plan. Except as noted below, claims of secured creditors would be paid in full, including post-petition interest, but with instruments that are likely to bear interest rates that are lower than in existing arrangements. Unsecured claims generally would receive notes of Reorganized EPE and/or CSW common stock equal to 95.5% of their allowed claims, and post-petition interest beginning on the dates noted below through the Effective Date at 90-day LIBOR plus 200 basis points. Other classes of claims are unimpaired, including claims related to pollution control revenue bonds, as noted. All members of a class would receive the treatment provided for the class, regardless of whether the member voted in favor of the Plan.

Class 1 - First Mortgage Bonds. Allowed claims arising from the Company's First Mortgage Bonds (excluding bonds held as collateral to secure other debt of the Company) would be paid in full through the issuance of Reorganized EPE First Mortgage Bonds (Series A and B) in the amount of the principal of the First Mortgage Bonds and unpaid interest on such bonds. In addition, the unpaid interest prior to July 1, 1992 on the First Mortgage Bonds would accrue interest at 90-day LIBOR plus 200 basis points from the due date of each installment of interest through the Effective Date. Such interest on interest would be paid in cash at the Effective Date.

The Company has paid interest monthly on the First Mortgage Bonds at the contract non-default rate from July 1, 1992 through the current date pursuant to applicable orders of the Bankruptcy Court and intends to do so through the Effective Date.

Class 2 - Second Mortgage Bonds. Allowed claims arising from the Company's Second Mortgage Bonds (excluding bonds held as collateral to secure other debt of the Company) would be paid in full through the issuance of Reorganized EPE Second Mortgage Bonds in the amount of the principal Second Mortgage Bonds and unpaid interest prior to July 1, 1992 on such bonds. In addition, the unpaid interest on the Second Mortgage Bonds would accrue interest at 90-day LIBOR plus 200 basis points from the due date of each installment of interest through the Effective Date. Such interest on interest would be paid in cash at the Effective Date.

The Company has paid interest monthly on the Second Mortgage Bonds at the contract non-default rates from July 1, 1992 through the current date pursuant to applicable orders of the Bankruptcy Court and intends to do so through the Effective Date.

Class 3 - Revolving Credit Facility. Allowed claims arising from or related to the RCF, which are secured by First Mortgage Bonds and Second Mortgage Bonds, would be discharged through the issuance, in the amount of the outstanding principal balance of the RCF plus interest accrued through

June 30, 1992, of either (a) Secured Notes of Reorganized EPE under a term loan agreement in the amount of the claim secured by a combination of pledged Reorganized EPE First Mortgage Bonds and Reorganized EPE Second Mortgage Bonds or (b) at the creditors' election, subject to certain limitations, Reorganized EPE First Mortgage Bonds in an amount equal to one-third of the claims and Reorganized EPE Second Mortgage Bonds in an amount equal to two-thirds of the claims. In addition, interest on the unpaid interest would accrue at the contract non-default rate through the Confirmation Date and would accrue at 90-day LIBOR plus 150 basis points from the Confirmation Date through the Effective Date. Such interest on interest would be payable in cash on the Effective Date.

The Company has paid interest monthly on the claims under the RCF from July 1, 1992 through the current date pursuant to applicable orders of the Bankruptcy Court and anticipates it will continue to do so through the Effective Date. If such interest is not paid, then interest would accrue on the unpaid interest at higher contract default rates.

Class 4 - Claims Under Three Series of Pollution Control Bonds. Class 4 consists of claims arising under or related to three series of pollution control bonds that are secured by Second Mortgage Bonds. These claims are considered unimpaired. The pollution control bonds would remain outstanding and any claims would be unaltered by the Plan. It is contemplated that certain modifications to the documents governing the bonds would be made after the Effective Date and the bonds remarketed or refunded soon after the Effective Date.

Class 5 - Claims Relating to the Letters of Credit Associated with the Three Series of Pollution Control Bonds (Class 4). The issuers of letters of credit associated with the three series of secured pollution control bonds have committed to provide replacement letters of credit on certain terms. The issuers would receive Secured Notes from Reorganized EPE under term loan agreements, secured by pledged Reorganized EPE Second Mortgage Bonds, with respect to outstanding draws on the existing letters of credit and accrued interest on such unreimbursed draws through July 7, 1993. In addition, interest on the certain amounts of unpaid interest and unreimbursed draws would accrue from July 8, 1993 through the Effective Date at rates related to contract rates, and would be paid in cash on the Effective Date. Unpaid letter of credit fees also would be paid on the Effective Date.

Subsequent to the Confirmation Date, the Company has been reimbursing the issuing banks all amounts drawn on the letters of credit for the payment of interest on the three series of pollution control bonds whose claims are included in Class 4.

The reimbursement obligations under the replacement letters of credit (post-Effective Date) would be secured by pledged Reorganized EPE Second Mortgage Bonds. If a letter of credit issuer does not provide a replacement letter of credit, it would receive Reorganized EPE Second Mortgage Bonds for claims the Bankruptcy Court determines are secured claims and Senior Fixed Rate Notes for claims determined to be unsecured claims.

Class 6 - Claims Asserted by the Nuclear Fuel Trust. Class 6 consists of claims related to the trust established for purposes of financing the purchase and enrichment of nuclear fuel for use by the Company at Palo Verde. Holders of claims in Class 6 would receive, at the holder's election, either (a) Secured Notes of Reorganized EPE secured by pledged Reorganized EPE Second Mortgage Bonds or (b) Reorganized EPE Second Mortgage Bonds. In addition, an amount equal to 85% of the interest accrued and unpaid through September 10, 1993 would be paid in cash at the Effective Date.

Interest on the principal amount of the claims of approximately \$1.3 million accrued from September 10, 1993 through the Confirmation Date and was paid at the Confirmation Date. From the Confirmation Date to the Effective Date, interest will accrue on the principal amount of the claims at 90-day LIBOR plus 200 basis points and will be payable quarterly and at the Effective Date.

Class 7 - Other Allowed Secured Claims. These claims, which consist of any other secured claims, are unimpaired and, at the option of the Company and CSW, would receive one of the following treatments: (a) be paid in full in cash at the Effective Date; (b) be reinstated and remain unaltered by the Plan; (c) have defaults cured and the obligation reinstated; or (d) receive the collateral.

Class 8 - Allowed Priority Claims. The claims, which consist of allowed claims with priority under certain provisions of the Bankruptcy Code, are unimpaired and such claims would be unaltered by the Plan.

Class 9 - Allowed Customer Refund and Deposit Claims. The claims, which are all allowed claims by the Company's customers for refunds and deposits that are not Class 8 claims, would be unimpaired and such claims would be unaltered by the Plan.

Class 10 - Claims Under One Series of Pollution Control Bonds. Class 10 consists of claims arising under agreements related to one series of pollution control bonds, which are not secured. The claims are unimpaired and the pollution control bonds would remain outstanding and any claims would be unaltered by the Plan. It is contemplated that certain modifications to the documents governing the bonds would be made and the bonds remarketed or refunded soon after the Effective Date.

Class 11 - Claims Related to Letter of Credit Associated with the Series of Pollution Control Bonds (Class 10). The issuer of the letter of credit has committed to provide a replacement letter of credit on certain terms. The allowed claims of Class 11 would be the unreimbursed amounts drawn on the letter of credit (with exceptions for amounts drawn to pay principal) and unpaid letter of credit fees. The claims would be discharged by the issuance of Senior Notes of Reorganized EPE in a principal amount equal to 30% of the allowed claims, CSW common stock equal to 60% of the allowed claims and, at the election of Reorganized EPE, Senior Notes of Reorganized EPE or CSW common stock equal to 5.5% of the allowed claims. In the event there is a draw on the existing letter of credit before the Effective Date to pay the principal amount of the purchase price of any of the pollution control bonds that have not been cancelled or extinguished, the claim would be discharged by Senior Floating Rate Notes under a term loan agreement.

In addition, holders of Class 11 claims will accrue interest at 90-day LIBOR plus 200 basis points on 95.5% of the principal amount of the claims from June 25, 1993 through the Effective Date (and on 100% of the amount of any letter of credit draw to pay the principal of any pollution control bonds). Interest totaling approximately \$101,000 through the Confirmation Date was paid at the Confirmation Date. Interest will be paid quarterly thereafter and at the Effective Date.

Reimbursement obligations under the replacement letter of credit (post-Effective Date) would be secured by pledged Reorganized EPE Second Mortgage Bonds. If the letter of credit issuer does not provide a replacement letter of credit, allowed claims would be discharged through Senior Fixed Rate Notes equal to one-third of the claims and CSW common stock equal to two-thirds of the claims.

Class 12 - Claims Related to Palo Verde Leases, Palo Verde Lease Obligation Bonds and Palo Verde Secured Lease Obligation Bonds. Class 12(a) consists of holders of Palo Verde Lease Obligation Bonds and Secured Lease Obligation Bonds and the amount of allowed claims is stipulated to be \$700 million. The \$700 million allowed claims would be discharged through the pro rata distribution of the following securities in the amount of 95.5% of the allowed claims: Senior Notes of Reorganized EPE in an amount not less than one-third and not more than two-thirds of the amount distributed for such claims and the remainder in CSW common stock. Class 12 (b) consist of the Owner Participants, who in addition to the Owner Trustee, have entered into settlement agreements with the Company. The Owner Participants would transfer their interests in leased Palo Verde assets to the Company, release their claims for any additional damage amounts under the Palo Verde Leases, retain \$288.4 million previously drawn on letters of credit, and be released from claims by the Company and

be indemnified by the Company from claims of third parties, as provided in the settlement agreements.

In addition, holders of Class 12(a) claims will accrue interest at 90-day LIBOR plus 200 basis points on 95.5% of \$700 million from July 29, 1993 through the Effective Date. Interest totaling approximately \$14.4 million through the Confirmation Date was paid at the Confirmation Date. Interest will be payable quarterly thereafter and at the Effective Date. The amounts paid have been offset against amounts accrued in connection with the Palo Verde Leases. See Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operation - Liquidity and Capital Resources - Obligations Subject to Compromise - ANPP Participation Agreement."

Class 13 - Unsecured Claims. Class 13 consists of general unsecured prepetition claims in excess of \$100,000, which would be discharged by the issuance of a combination of notes of Reorganized EPE and CSW common stock as follows: Senior Notes in an amount equal to 30% of the claims, CSW common stock equal to 60% of the claims, and, at the option of Reorganized EPE, Senior Notes or CSW common stock equal to 5.5% of the claims.

In addition, holders of Class 13 claims will accrue interest at 90-day LIBOR plus 200 basis points on 95.5% of the principal amount of their claims from June 25, 1993 through the Effective Date. Interest totaling \$8.2 million through the Confirmation Date was paid at the Confirmation Date. Interest will be payable quarterly thereafter and at the Effective Date.

Class 14 - Unsecured Claims Up to \$100,000. General unsecured claims up to \$100,000 are unimpaired and would be paid in cash at the Effective Date.

Class 15 - Preferred Stock Interests. See "Consideration to Shareholders Pursuant to the Plan and Merger Agreement," below.

Class 16 - Common Stock Interests. See "Consideration to Shareholders Pursuant to the Plan and Merger Agreement," below.

Payment of Cash in Lieu of CSW Common Stock. The Plan provides for the issuance of CSW common stock to holders of allowed claims in Classes 11, 12(a), 13 and, possibly, 15 to satisfy a percentage of their allowed claims. Pursuant to the terms of the Plan, CSW could elect to pay holders of allowed claims in such classes cash on the Effective Date in an amount equal to the value of some or all of the CSW common stock that would have been distributed. If CSW elects to pay cash in lieu of CSW common stock, it must be on a pro rata basis to the holders of allowed claims in Classes 11, 12(a) and 13, and no holders of allowed Class 15 claims could receive cash in lieu of CSW common stock unless cash had been paid in lieu of all CSW common stock that would have been distributed to holders of allowed claims in Classes 11, 12(a) and 13.

Restrictions on the Transfer of CSW Common Stock Issued Pursuant to the Plan. The Plan contains provisions that would restrict the transfer of CSW common stock issued under the Plan for a period of time following the Effective Date. For shares of CSW common stock that would be issued to holders of allowed claims in Classes 11, 12(a) and 13, there would be graduated lock-up periods such that one-third of the shares of CSW common stock would be eligible to be transferred immediately, two-thirds would be eligible for transfer after 90 days from the Effective Date and 100% would be eligible for transfer after 180 days from the Effective Date. For shares of CSW common stock that would be issued to holders of allowed Class 15 and Class 16 interests, no such shares would be eligible for transfer until 240 days after the Effective Date. To enforce the restrictions, the Plan provides for the delayed issuance or escrow of shares of CSW common stock through the applicable lock-up periods. Holders of such shares would be compensated for the dividends that would have been paid on such shares, either at the time of payment or at the end of the lock-up periods. Holders who would receive

no more than 5,000 shares of CSW common stock in satisfaction of their allowed claims or interests as of the Effective Date would be exempt from the restrictions on transfer.

Interim Distributions Under the Plan. As discussed above, the Plan required the Company to make payments to certain classes of creditors at the Confirmation Date and thereafter until the Effective Date of the Plan, or until further order of the Bankruptcy Court. These payments are in addition to periodic interest payments on secured debt that the Company has been making since July 1, 1992 pursuant to applicable orders of the Bankruptcy Court. The interim payments are intended to compensate the holders of the claims during the period from the Confirmation Date to the Effective Date. These interim payments consist of (i) amounts characterized as interest on unsecured and undersecured debt and on the claims of the holders of the bonds related to the Palo Verde Leases; (ii) amounts characterized as periodic payments to holders of the Company's preferred stock, which the Bankruptcy Court has ruled are not dividends; and (iii) fees of professional advisors (including attorneys) and other expenses of certain classes of creditors and interest holders. Pursuant to these provisions of the Plan, at the Confirmation Date the Company paid a total of approximately \$24 million in interest and approximately \$1.1 million to the holders of the Company's preferred stock for the period to the Confirmation Date. In addition, the Company paid or has accrued a total of approximately \$13.8 million for fees and expenses, including fees of attorneys and financial advisors of creditors and interest holders, incurred through the Confirmation Date, as provided under the terms of the Plan. The Company estimates that interest payments and periodic payments aggregating approximately \$15.4 million per quarter will be made through the Effective Date of the Plan. These estimates of interim payments do not include payments on secured debt of approximately \$5 million per month that the Company has been making.

Consideration to Shareholders Pursuant to the Plan and Merger Agreement

Common Stock. At the Effective Date, the issued and outstanding shares of Company common stock (other than treasury shares and any shares held by CSW or CSW Sub) would be converted into CSW common stock. Outstanding options to purchase common stock of the Company would be converted into options to purchase shares of CSW common stock. The conversions would be based on the ratio of the number of shares of CSW common stock credited to the CSW Common Stock Acquisition Fund (which is defined in the Merger Agreement and is referred to herein as the "Fund") to the number of outstanding shares of the Company's common stock at the Effective Date. The Fund is a system for tracking the consideration that the Company's common shareholders would receive through the Merger, including the additional consideration that can be achieved through the Company's resolution of certain matters, such as the settlement of certain claims and the realization of certain assets. The maximum amount of additional consideration that can be obtained is \$1.50 per share of the Company's common stock outstanding on the Confirmation Date, or approximately \$53.3 million (the "Maximum Consideration Amount"). No shares of CSW common stock or cash actually are placed in the Fund. The Fund was created on the Confirmation Date and, on that date, a total of 3,699,573 shares of CSW common stock were credited to the Fund, based on (i) a value of \$3.00 per share of the Company's common stock, (ii) 35,544,330 shares of Company common stock outstanding on the Confirmation Date, (iii) an average trading price of \$29.4583 for CSW common stock, and (iv) the realization prior to the Confirmation Date of approximately \$2.3 million in additional consideration through the resolution of certain litigation. As items specified in the Merger Agreement in connection with the additional consideration are resolved, additional shares of CSW common stock will be credited to the Fund. Pursuant to the terms of the Merger Agreement, the number of additional shares will be determined based on the amount realized, the date of resolution of the item and the closing price of CSW common stock on such date. Pursuant to the Second Amendment to the Merger Agreement, as a result of the proposed settlements with the Owner Participants in the Palo Verde sale/leaseback transactions and APS on certain claims, an additional amount of up to \$13.8 million will be added to the additional consideration one day prior to the Effective Date, if and to the extent the Maximum Consideration Amount has not been reached.

In June 1993, the Company acquired all of the outstanding stock of Triangle Electric Supply Company, Inc. ("Triangle Electric") as a result of the settlement of certain litigation. On March 22, 1994, the Bankruptcy Court entered an order approving the sale by Triangle Electric of substantially all of its assets (excluding cash and cash equivalents) at net book value, subject to certain adjustments, plus \$1,550,000 for a covenant not to compete. The Company has filed a notice with the New Mexico Commission seeking prior approval of the disposition. The Company estimates that, upon the closing of the transaction, approximately \$10 million of additional consideration will be credited to the Fund. Pursuant to the Merger Agreement, additional shares of CSW common stock would be credited to the Fund based on the amount of additional consideration ultimately realized and the closing price of CSW common stock on the date the matter is resolved.

The Company also has filed a motion with the Bankruptcy Court seeking approval of a settlement with the IRS related to their claim against the Company for prepetition tax years. If approved, the settlement would result in the resolution of the IRS's proof of claim for approximately \$6.2 million. Pursuant to the Merger Agreement, the settlement would generate approximately \$27.8 million of additional consideration (the difference between \$34.0 million and the \$6.2 million proposed settlement with the IRS). The Merger Agreement provides that additional shares of CSW common stock would be credited to the Fund based on the \$27.8 million of additional consideration and the closing price of CSW common stock on the date of resolution. See Item 3, "Legal Proceedings – Tax Matters – Federal Tax Matters." If the Company realizes the additional consideration as discussed above, the Maximum Consideration Amount would be achieved for the common shareholders. The Company will continue to resolve all matters that can result in additional consideration.

In addition to the shares credited to the Fund in connection with the Maximum Consideration Amount, as described above, shares of CSW common stock will be credited to the Fund through the Effective Date based on the aggregate dividends that would have been paid on the shares of CSW common stock credited to the Fund. The number and timing of shares of CSW common stock credited for dividends will be determined as provided in the Merger Agreement, and is based on the closing price of CSW common stock on the dividend payment date and the number of shares credited to the Fund on the ex-dividend date for payment of CSW dividends. As of March 15, 1994, 3,757,009 shares of CSW common stock have been credited to the Fund, including 57,436 shares of CSW common stock based on payments of dividends on CSW common stock. CSW common stock is traded on the New York Stock Exchange, symbol CSR. The closing price for CSW common stock on March 15, 1994 was \$26.00 per share.

If the Maximum Consideration Amount described above has not been realized, then as of the Effective Date the Company would establish a liquidation trust (the "Liquidation Trust"), assign thereto all of the Company's rights to and interests in certain contingent items described in the Merger Agreement which are not disposed of or determined prior to the Effective Date, and advance to the Liquidation Trust cash (not to exceed \$1,000,000) for expenses of the trustee of the Liquidation Trust. Any cash proceeds in the Liquidation Trust (after payment of expenses related to the operation of the Liquidation Trust) resulting from dispositions of the assets or from such reductions in claims determined after the effective date would be distributed pro rata to the holders, as of the Effective Date, of the Company's common stock until the Maximum Consideration Amount has been reached and then would be returned to the Company.

If another plan of reorganization involving CSW or an affiliate of CSW were to become effective, then pursuant to terms of the Merger Agreement, unless the Company has withdrawn the Plan or proposed a stand-alone plan of reorganization inconsistent with the Merger Agreement or has breached the Merger Agreement in a material manner, CSW would be required to pay to holders of the Company's common stock an amount equal to the difference between the aggregate amount that would have been paid to such holders under the Plan and the amount actually paid under the other plan of reorganization (the "Price Protection").

Preferred Stock. Pursuant to the Plan, the allowed interests of preferred shareholders would be the sum of (a) the aggregate amount of the redemption prices on the Effective Date of the preferred stock and (b) the aggregate amount of dividends accrued and unpaid prior to the bankruptcy filing on January 8, 1992 (two quarters of dividends). These interests would be satisfied under the Plan by the issuance of securities having a value in the amount of \$68 million. Under the Plan, the Company's preferred stock would be converted to either (a) shares of Reorganized EPE Preferred Stock or (b) if CSW so elects before December 8, 1994, a combination of shares of Reorganized EPE Preferred Stock and CSW common stock.

In addition, periodic payments will accrue from August 20, 1993 to the Effective Date at the rate of 90-day LIBOR plus 200 basis points on the amount of the preferred stock distribution amount. Payments totaling \$1.4 million were made through December 31, 1993.

Termination of Merger Agreement

CSW has the right to terminate the Merger Agreement if certain events, including but not limited to the following, occur:

- (i) the Company withdraws or modifies in a manner adverse to CSW its recommendation or approval of the Plan, the Merger Agreement or the Merger, or approves or recommends a proposal or acquisition with a party other than CSW or a subsidiary of CSW;
- (ii) a material breach of any representation, warranty, covenant or agreement of the Merger Agreement by the Company;
- (iii) failure to obtain any required statutory approvals or regulatory determinations that are conditions to the effectiveness of the Merger or the inability to satisfy any other conditions to the effectiveness of the Plan and Merger; or
- (iv) the Company files an independent case related to rates before the Texas Commission, except as permitted by the Merger Agreement.

The Company has the right to terminate the Merger Agreement if any of the following events occur:

- (i) failure to obtain any required statutory approvals or regulatory determinations that are conditions to the effectiveness of the Plan and Merger;
- (ii) material breach of any representation, warranty, covenant or agreement of the Merger Agreement by CSW;
- (iii) CSW withdraws or modifies in a manner adverse to the Company its recommendation or approval of the Plan, the Merger Agreement or the Merger; or
- (iv) the Company determines in accordance with its fiduciary duties as debtor-in-possession to engage in an acquisition transaction with a party unrelated to CSW.

Either party may terminate the Merger Agreement if (i) the Effective Date has not occurred within 18 months (or, if extended by the parties, within 24 months) of the Confirmation Date; or (ii) prior to the Effective Date the Plan is terminated or the confirmation order is vacated or reversed.

In the event the Merger Agreement is terminated, it shall become void and, other than (i) the possible payment of a termination fee, by the Company or CSW to the other party; (ii) the possible payment of the Price Protection; and (iii) under certain circumstances, the reimbursement to the

Company by CSW of certain costs, interest and expenses related to the Merger borne by the Company, there is no other obligation or liability on the part of the Company, CSW or CSW Sub. Termination fees of \$25 or \$50 million (in the case of any payments due from the Company to CSW) or \$25 million (in the case of any payment due from CSW to the Company) are payable only in limited circumstances. The amount of the termination fee payable by the Company, if any, depends on the reason for termination.

Actions Related to Bankruptcy Case Prior to the Effective Date

Prior to the Effective Date, current management of the Company will continue to manage and run the Company, subject to the oversight of the Board of Directors and required approvals of the Bankruptcy Court for certain actions. Under the Merger Agreement, the Company is prohibited from undertaking certain actions, which generally are extraordinary in nature; may be required to notify or obtain the approval of CSW prior to undertaking other actions; and its ability to take certain actions is limited in other respects. With those limitations, the Company is continuing to operate and complete the actions required to reach the Effective Date.

Interim payments will be made prior to and at the Effective Date, as set forth in the Plan, and as described above in "Treatment of Claims Under the Plan." The Company and CSW continue to meet periodically with an oversight committee representing all classes of creditors to inform them of the status of the conditions to effectiveness of the Plan and to provide other information.

The Company is continuing its analysis of its executory contracts to determine whether the Company should assume or reject all or a portion of these contracts. The Company has motions pending to assume (i) the lease related to the Company's sale and leaseback transaction involving generation equipment at the Copper Power Station (the "Copper Lease"), to the extent the Copper Lease may in any respect be an unexpired lease of non-residential real property; and (ii) the lease, as amended, with the Navajo Nation in connection with the construction and operation of the Four Corners Project (the "Navajo Lease"). For a description of the Copper Power Station and Four Corners Project, see "Facilities - Copper Power Station" and "Facilities - Four Corners Project."

The Company also is continuing its analysis of the proofs of claim filed in the Bankruptcy Case in an effort to reconcile the claimants and the claimed amounts with the Company's books and records and, prior to the Effective Date, will determine which it will object to. The general deadline for filing creditors' claims against the Company with the Bankruptcy Court was June 15, 1992. Approximately 500 proofs of claim or interest had been filed with the Bankruptcy Court as of December 31, 1993. Many of the proofs of claim are voluminous and duplicative. The Company's counsel is also involved in the process of analyzing the factual and legal bases of many of the proofs of claim.

Based on the evaluation to date, the following table represents the proofs of claims, exclusive of proofs of claims that have been withdrawn voluntarily or for which objections by the Company have been upheld and those for which amounts have been paid, as of December 31, 1993, that have been filed and that include a specified amount.

<u>Category of Claims</u>	<u>Amount</u> (In thousands)
Claims that correspond to Company books and records	\$ 1,220,095
Palo Verde lease obligation bond claims	743,082
Litigation claims	50,111
Tax claims	54,182
Executory contract claims	11,019
Other	19,748
Subtotal	<u>2,098,237</u>
Claims that are duplicative of the above	3,284,517
Total	<u>\$ 5,382,754</u>

The Company does not acknowledge the validity of any proofs of claim represented in the table and reserves its right to object to all proofs of claim. Claims related to the Palo Verde lease obligation bonds are unliquidated claims that are included in Class 12 under the Plan and would be allowed claims in the amount of \$700 million under the Plan. Tax claims represent unliquidated amounts related primarily to asserted tax deficiencies in federal income taxes, as discussed in Item 3, "Legal Proceedings – Tax Matters – Federal Tax Matters." Litigation claims primarily reflect miscellaneous personal injury litigation for which the Company has adequate liability insurance and commercial litigation. The Company believes that the duplicate claims will not be allowed claims in the Bankruptcy Case. The claims for executory contracts are for unliquidated damages for leases or other executory contracts the Company has not rejected. There also are approximately 70 proofs of claims that do not specify an amount and, therefore, are not reflected in the table above. The Company cannot predict the amount of claims that ultimately will be allowed by the Bankruptcy Court in the Bankruptcy Case.

Alternatives to the Plan

If the Plan does not become effective, the Company would consider other alternatives to the Merger, including another merger or business combination with an entity not affiliated with CSW, a stand-alone plan that would involve a restructuring under FERC jurisdiction or a stand-alone plan under existing regulatory frameworks. Under each of these alternatives, the treatment of Palo Verde and the pending adversary proceeding would present a major consideration.

The restructuring under FERC jurisdiction would result in a conversion of the Company into a holding company with integrated multiple corporate subsidiaries that would be subject to increased FERC regulation and, possibly, SEC regulation under the PUHCA. Operating subsidiaries would perform the electric generating operations of the Company, the operation of transmission facilities, its retail electric distribution operations in Texas, its retail electric distribution operations in New Mexico, and its general and administrative functions such as engineering, accounting, management and similar services.

It is also possible that the Bankruptcy Court would allow a third party to file a plan of reorganization that may involve a merger, business combination or acquisition.

Any plan of reorganization other than the Plan may provide for different securities and treatments than those provided in the Plan, and could result in lower recoveries for creditors and interest holders and/or could require larger rate increases than proposed pursuant to the Plan. The Company cannot predict (i) what the treatment of claims and interests would be under any alternate plan of reorganization, (ii) in what respects actions proposed under the Plan would be modified, or (iii) the amount of time that would be involved before any such alternate plan of reorganization were effective.

Although the Company believes it is unlikely, and the Bankruptcy Court has indicated it would be an undesirable outcome, if no other plan of reorganization proves viable, the Bankruptcy Court also could order the liquidation of the Company.

Regulation

Overview

Effect of Bankruptcy on Regulation. The Bankruptcy Code provides that the Bankruptcy Court shall confirm the Company's plan of reorganization only if "any governmental regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor has approved any rate change provided for in the plan, or such rate change is expressly conditioned on such approval." To date, the Company has not asserted arguments in the regulatory proceedings that the provisions of the

Bankruptcy Code, together with applicable provisions of other federal statutes, grant the Bankruptcy Court the authority to preempt otherwise applicable regulatory authority and processes, and it is uncertain whether the Company would prevail on such arguments, if asserted. As discussed above, in "Bankruptcy Proceedings for Reorganization of the Company – Regulatory Aspects of the Plan and Merger," the Company or, where appropriate, CSW or APS, have filed or will file applications with various regulatory bodies to seek approvals or findings necessary to consummate the Merger and otherwise satisfy the conditions to the effectiveness of the Plan. The discussion of the applications filed or to be filed before the regulatory bodies pursuant to the Plan and the pending regulatory appeals discussed below in "Texas Rate Matters" and "New Mexico Rate Matters" should be read in the context of the preemption issue discussed above.

On June 11, 1992, an agreed order was entered in the Bankruptcy Court pursuant to which appeals in Dockets 7460, 8588, and 9165 (discussed below in "Texas Rate Matters") may go forward in state court and, upon remand, before the Texas Commission. The agreed order provided that it was not a determination of the applicability of the automatic stay in bankruptcy as to any other regulatory appeal or a determination of the jurisdiction of the Bankruptcy Court or any other court or regulatory authority with respect to the Company's rates or service. On September 20, 1993, the Bankruptcy Court entered an order lifting the automatic stay in the appeals of the Company's other Texas rate proceedings, consisting of Dockets 9945, 8018, 8078, 8363, and 9069 (discussed below in "Texas 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 largest municipality in the Company's service area in Texas is the City of El Paso. 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.

The Texas Commission has jurisdiction to grant and amend CCNs for service territory and certain facilities, including generation and transmission facilities. Although the Texas Commission does not have the authority to approve transfers of utility assets, it is required to evaluate certain transfers of utility assets and mergers and consolidations of regulated utility companies to determine if those transactions are consistent with the public interest. Upon a finding that such a transaction is not in the public interest, the Texas Commission is required to consider the effects of the transaction in future ratemaking proceedings and is required to disallow the effects of the transaction if it will unreasonably affect rates or service.

New Mexico. The New Mexico Commission has jurisdiction over the Company's rates and services in New Mexico. The New Mexico Commission must grant prior approval of the issuance, assumption or guarantee of securities; the creation of liens on property located within the state; the consolidation, merger or acquisition of some or all of the stock of another utility; and the sale, lease, rental, purchase or acquisition of any public utility plant or property constituting all or part of an operating unit or system. The New Mexico Commission also has jurisdiction as to the valuation of utility property and business; certain extensions, improvements and additions; Class I and II transactions (as defined by the New Mexico Public Utility Act); abandonment of facilities and the certification and decertification of utility plant.

Federal Energy Regulatory Commission. The Company is subject to regulation by the FERC in certain matters, including rates for wholesale power sales and the issuance of securities. In 1992, the Congress enacted the Energy Policy Act, which, among other things, removes certain restrictions on utility participation in the competitive wholesale generation market. In addition, subject to certain limitations, the legislation provides that the FERC also may order electric utilities, including the Company, to provide certain transmission services. The legislation also expands the authority of state utility commissions to examine the books and records of electric utilities. See "Bankruptcy

Proceedings for Reorganization of the Company — Regulatory Aspects of the Plan and Merger," above.

Nuclear Regulatory Commission. The Palo Verde Station is subject to the jurisdiction of the NRC, which has authority to issue permits and licenses, 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 at Palo Verde for terms of forty years each, beginning December 31, 1984, December 9, 1985 and March 25, 1987, respectively. Full power operating licenses for Units 1, 2 and 3 were issued by the NRC in June 1985, April 1986 and November 1987, respectively. In addition, the Company (along with the other Palo Verde Participants other than APS) is separately licensed by the NRC to own its proportionate share thereof. See "Facilities – Palo Verde Station." On January 13, 1994, APS, as Operating Agent of Palo Verde, joined by the Company, filed a request with the NRC (i) for consent to the indirect transfer of the Company's possession and ownership in the Operating Licenses for Palo Verde Units 1, 2 and 3 that will occur as a result of the merger of a special-purpose subsidiary of CSW with and into the Company; and (ii) to amend the Operating Licenses for Units 2 and 3 to delete provisions of those licenses related to the Company's sale and leaseback transactions involving those units. The request to the NRC specifies that the requested amendments to the Operating Licenses and consent become effective on the Effective Date, upon notification by the applicants that all necessary regulatory approvals have been obtained, but the Company cannot predict at this time whether and when the approvals and consent will be granted. See "Bankruptcy Proceedings for Reorganization of the Company – Regulatory Aspects of the Plan and Merger," above.

Accounting for the Effects of Regulation. Prior to December 31, 1991, the financial statements of the Company were prepared pursuant to the provisions of SFAS No. 71, as amended, "Accounting for the Effects of Certain Types of Regulation," which provides for the recognition of the economic effects of regulation. In early 1992, the Company determined that there existed substantial doubt concerning whether the criteria for reflecting the economic effects of regulation continued to be met as a result of continuing cash flow problems arising from inadequate rate relief and the uncertainty surrounding regulation during the reorganization process, including the regulatory treatment, if any, of the \$288.4 million letters of credit draws. The Company concluded that it was not reasonable to assume that its rates were, or will be, without giving consideration to possible outcomes of the reorganization process, designed to recover its costs on a timely basis. Because of the uncertainty of the nature of any reorganization plan ultimately consummated and the assessment of the nature of regulation, the Company concluded that it did not then and does not currently have sufficient assurance to reflect the economic effects of regulation in its general purpose financial statements. Therefore, as required by generally accepted accounting principles, the Company eliminated from its 1991 balance sheet the aggregate effects of regulation, which resulted in a \$311 million extraordinary charge to results of operations for the year ended December 31, 1991. This amount included approximately \$200 million of operating expenses primarily related to Palo Verde and approximately \$80 million of income taxes related to the Palo Verde sale/leaseback transactions which had been deferred by the Company's regulators for recovery in future periods. Furthermore, the Company did not record the letter of credit draws amounting to \$288.4 million as an asset and has not recorded any new assets reflecting the economic effects of regulation since 1991 in its general purpose financial statements.

Although the outcome of the reorganization process cannot presently be determined, the Company believes that the rates established in conjunction with any reorganization plan will be designed to recover the Company's costs, including a return on equity, after the establishment of an appropriate capital structure, as well as to reflect other changes that may result from the reorganization. The Company expects that, upon effectiveness of any plan of reorganization, its regulated operations will meet the SFAS No. 71 criteria necessary to reflect the effects of regulation in its general purpose financial statements. Such rates may include the recovery of some or all items

that, at that time, are not reflected as regulatory assets on the Company's general purpose financial statements. However, in the absence of application of purchase accounting applied in the event of a change in control occurring as part of the reorganization, there does not appear to be any applicable accounting precedent for the restoration of such amounts as assets created prior to the re-adoption of SFAS No. 71. Restoration of such amounts as assets will depend upon a number of factors, including intervening developments in accounting standards and other accounting literature, the outcome of which cannot currently be determined. In March 1993, the Financial Accounting Standards Board's Emerging Issues Task Force reached a consensus that if a rate-regulated enterprise initially fails to meet the regulatory asset recognition requirements of SFAS No. 71, but meets those requirements in a subsequent period, then regulatory assets should be recognized in the period the requirements are met. Although the Emerging Issues Task Force's consensus applied to rate-regulated enterprises currently meeting the requirements of SFAS No. 71, the Company believes that this consensus supports the Company's position regarding restoring previous net regulatory assets in its general purpose financial statements. In the event it is concluded that such restoration is not appropriate under generally accepted accounting principles, the Company would be precluded from recognizing historical amounts as regulatory assets in its general purpose financial statements. If it is determined that such restoration is appropriate, regulatory assets would be recorded to the extent items allowed to be recovered in the rate making process have not been reflected as assets in the Company's general purpose financial statements.

Texas Rate Matters

Rate Moderation Plan – Palo Verde Units 1 and 2. In 1988 the Texas Commission established a rate moderation plan in Docket 7460 based on a contested stipulation, pursuant to which the Texas jurisdictional portion of the Company's investment in Palo Verde Unit 1, Common Plant, and lease payments on Unit 2 (to the extent of approximately 83% of those lease payments) were to be phased-in to rates in four steps. The order in Docket 7460 also settled all issues concerning the prudence of the Company's initial decision to participate in Palo Verde and all issues concerning prudence in the construction of Units 1 and 2. (The prudence of the Company's decision to continue its investment in Unit 3 after 1978 and the prudence in the construction of Unit 3 were the subject of Docket 9945, discussed below.) The Docket 7460 order was upheld by the Texas Court of Appeals for the 3rd Judicial District at Austin, Texas (the "Court of Appeals"), on August 26, 1992, except for a determination that deferred carrying costs may not be included in rate base. The case has been appealed to the Texas Supreme Court by the Company and other parties. See discussion below under "Deferred Accounting Cases."

The first base rate increase contemplated under the rate moderation plan was ordered in Docket 7460, and the remaining three increases were sought and ordered in subsequent rate filings (Dockets 8363, 9165, and 9945). As a result of these filings, the Texas Commission has allowed periodic rate increases which allow the Company to recover some, but not all, of its revenue requirements associated with its investment in Units 1 and 2 (as established in these rate cases), and the Company has been permitted to defer those unrecovered revenue requirements on its regulatory books of account for collection in later years. In Docket 9945, the Texas Commission limited each future base rate increase intended to recover those deferrals to 3.5%. In connection with the Company's discontinuation of reporting under SFAS No. 71 as of December 31, 1991, approximately \$46.1 million of "phase-in deferrals" previously recorded pursuant to this plan have been eliminated from the Company's general purpose financial statements and reported as part of the extraordinary charge to results of operations for the year ended December 31, 1991.

Dockets 8363 and 9165 have been appealed to the Texas District Court, where the appeals remain pending. A hearing on the appeal of Docket 8363 has been scheduled for July 1994. No hearing on the appeal of Docket 9165 has been scheduled. The outcome of these appeals and the results or materiality of final dispositions of these cases presently cannot be determined.

Docket 9945. On December 28, 1990, the Company filed with the Texas Commission a combined request for the scheduled fourth base rate increase under the Docket 7460 rate moderation plan discussed above and for the recovery, also on a moderated basis, of the Texas jurisdictional portion of the Company's investment in Palo Verde Unit 3, including the lease payments, net of deferred gain, on the Company's sales and leasebacks of a portion of its interest in Unit 3. The Company's combined request was for \$131.3 million, which included approximately \$49 million related to the Units 1 and 2 rate moderation plan and approximately \$82.3 million related to Unit 3. Of the total request, approximately \$38 million was to be in cash with the balance deferred for subsequent recovery.

The Texas Commission issued its final order in Docket 9945 on November 12, 1991, approving a total increase in Texas base revenues of approximately \$47 million, consisting of \$37 million in cash and \$10 million of phase-in deferrals. The order approved a cash increase of approximately \$7 million as the fourth increase under the Units 1 and 2 rate moderation plan with a phase-in deferral of \$10 million for future recovery in rates. The order limited each future increase in base rates under the Units 1 and 2 plan to 3.5%, but also approved a regulatory non-cash revenue adjustment recommended by the Hearing Examiners, which was necessary to provide for full recovery of the phase-in deferrals during the remaining term of the Units 1 and 2 rate moderation plan. The balance of the \$37 million cash increase (approximately \$30 million) represented operating and maintenance expenses, decommissioning expenses and ad valorem taxes on Unit 3 of Palo Verde, as well as an allowance for purchased power capacity. The balance did not include any current return of or return on the owned portion of Unit 3 or recovery of the lease expenses related to Unit 3. Recovery of these costs has been held in abeyance to be included subsequently in Texas rates over a scheduled period of time, as discussed below.

The Texas Commission disallowed approximately \$32 million of Unit 3 capitalized costs, on a total Company basis, as imprudently incurred. The order also disallowed \$9.8 million, on a total Company basis, of previously deferred costs related to the 1989-90 outages of Units 1 and 2. The Company recorded pre-tax write-offs of \$24.1 million and \$6.3 million, respectively (the Texas jurisdictional amounts of these disallowances), in results of operations in the third quarter of 1991.

With respect to the rate treatment of Unit 3, the Texas Commission adopted an inventory plan, pursuant to which the Company's investment in Unit 3 was neither included in rates nor expressly disallowed, but instead held in abeyance to be included subsequently in Texas rates over a scheduled period of time. In justifying the inventory plan, the Texas Commission found (i) the Company was imprudent in not attempting to sell a portion of its interest in Palo Verde between 1978 and 1981; (ii) the Company failed to demonstrate that it would not have been unable to sell such interest if it had attempted to do so; and (iii) as a result of such imprudent action, the addition of Unit 3 to the Company's system would result in excess capacity. However, the Texas Commission further found that Unit 3 would become "used and useful" to the Texas jurisdiction in the following percentages: 0% (in Docket 9945), and 40%, 65%, 85% and 100% thereafter. It is the Company's position that the successive phases of the inventory plan were to be implemented on an annual basis; however, other parties may contest that position. Other parties also may contest whether the inventory plan constituted a proper determination by the Texas Commission of when Unit 3 would become used and useful. During the period Unit 3 is held in inventory, the Company will recover the operating and maintenance expenses, decommissioning expenses and ad valorem taxes associated with Unit 3, along with an allowance for purchased power capacity. Pursuant to the order, but subject to possible changes that could result from an effective reorganization plan, the Company expects to recover, in future years, the following at the applicable inventoried percentages: a return of and on the plant costs associated with the owned portions of Unit 3 and the amount of lease payments due under the sale and leaseback transactions the Company entered into in connection with Unit 3. Under the order, the Company will retain the benefits of its sales to CFE for at least the period covered by the first rate order under the inventory plan. For a discussion of the sales to CFE, see Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations - Results of Operations."

The Company disputes there was any imprudence, either in connection with the Unit 3 capitalized costs or in retaining its full investment in Palo Verde. The Company challenged both aspects of the Texas Commission's order in the Company's Motions for Rehearing and has continued such challenges on appeal. The Company filed an appeal with the Texas District Court on April 21, 1992. The City of El Paso and two intervenors also appealed. On October 27, 1993, the Texas District Court affirmed the final order of the Texas Commission except in two respects. The Texas District Court held the Texas Commission erred (i) by refusing to include certain disallowed utility expenses as deductions when computing federal income tax expense for ratemaking purposes and (ii) by granting rate base treatment for post-in-service deferred carrying costs associated with Palo Verde. The second holding is consistent with the decision of the Texas Court of Appeals in Docket 7460, discussed below under "Deferred Accounting Cases." The Company has appealed the decision, as have the City of El Paso and the two intervenors who were parties to the appeal before the Texas District Court. The ultimate outcome of the appeals and their results or the materiality thereof cannot be predicted at this time.

Deferred Accounting Cases. The Company has received a series of orders authorizing the deferral of operating costs incurred, and carrying charges accrued, on each unit of Palo Verde between the unit's in-service date and the date of its inclusion in Texas rates. Certain orders have also permitted the Company to include in rate base and amortize the deferred costs over the lives of Units 1 and 2 (approximately 40 years for ratemaking purposes). All of these "deferred accounting orders" have been appealed. The ultimate outcome of these appeals and their results or the materiality thereof cannot be predicted by the Company at this time.

The deferred accounting order in Docket 7460 (regarding Units 1 and 2) has been the subject of two rulings by the Court of Appeals and is currently pending before the Texas Supreme Court. In its first ruling on August 14, 1991, the Court of Appeals held that none of the deferred costs could be included in rate base. As a result of that ruling, the Company discontinued deferring for financial reporting purposes Unit 3 operating and maintenance expenses and related carrying costs as of July 1, 1991. The Company and other parties filed Motions for Rehearing, in response to which the Court of Appeals issued a subsequent ruling on August 26, 1992, holding that deferred *operating* costs may be placed in rate base. Although the Court of Appeals maintained its position that deferred carrying costs may not be included in rate base, it stated that its opinion did not preclude the recovery of carrying costs without rate base treatment. This would allow recovery of the carrying costs, but might not allow the Company to earn a return on the unamortized balance of those carrying costs. The Company estimates that the amount of return on such carrying costs previously included in revenue requirements authorized by the Texas Commission, on an unmoderated basis, is approximately \$33.4 million as of March 31, 1994. The Texas Supreme Court granted writ of error with respect to the issue of the propriety of deferred accounting orders and heard oral argument on the case on September 13, 1993 (along with three similar appeals involving other Texas electric utilities). The Texas Supreme Court has not issued its ruling on the appeals. If the Court of Appeals' decision is upheld by the Texas Supreme Court and remanded to the Texas Commission, it is possible that the return on the deferred carrying costs will not be refunded, but will instead be offset against the balance of unamortized phase-in deferrals. It is also possible that the Texas Commission could find that the inability to earn a return on deferred carrying costs has increased the Company's risk and could, correspondingly, adjust the Company's allowed rate of return such that the previously determined total revenue requirement would remain unchanged.

In connection with the Company's elimination of net regulatory assets from its balance sheet as of December 31, 1991, approximately \$94 million of Units 1 and 2 accounting deferrals and \$60.3 million of Unit 3 accounting deferrals have been eliminated and reported as part of the extraordinary charge to results of operations for the year ended December 31, 1991. If the Court of

Appeals decision is upheld and assuming no refund will be required (as discussed above), there will be no additional write-offs required in the Company's general purpose financial statements.

Rate Case Expenses Incurred in Docket 7460. The issue of recovery of expenses incurred by the Company and the City of El Paso in connection with Docket 7460 was severed from the issues ruled upon by the Texas Commission in that Docket and was assigned to a new Docket 8018 for consideration. On September 20, 1991, the Texas Commission issued its final order in the case and approved the reimbursement of approximately \$10.8 million for expenses incurred by the Company and approximately \$1.1 million for expenses incurred by the City of El Paso. The Texas Commission further directed that such amounts be surcharged to the Company's Texas customers over a one-year period, which the Company completed in November 1992. The City of El Paso filed an appeal of the Texas Commission's order in Docket 8018 with the Texas District Court, and oral arguments were held March 18, 1994. After hearing arguments, the Texas District Court affirmed the Texas Commission's decision. Further appeals by the City of El Paso are possible. The ultimate outcome of any such appeal and its result or the materiality thereof cannot be predicted at this time.

In connection with the Company's elimination of net regulatory assets from its balance sheet as of December 31, 1991, the unrecovered balance of all rate case expenses previously deferred, including cases other than Docket 7460, was eliminated. The Company expects that all of these costs ultimately will be collected in full from its Texas customers.

Texas Recognition of Palo Verde Sales and Leasebacks. In its Docket 8363 order and a separate order issued in August 1989 (Docket 8078), the Texas Commission found the Company's Unit 2 and Unit 3 sales and leasebacks to be in the public interest. The rulings, if upheld on appeal, would ensure that the Texas Commission will consider those transactions in connection with the Company's rate cases. The finding on the Unit 2 sales and leasebacks, in addition to findings regarding federal income tax expense and other ratemaking issues, is a part of the City of El Paso's appeal of the Docket 8363 order. The City of El Paso appealed the Texas Commission's order in Docket 8078 with respect to the Unit 3 transactions to the Texas District Court. A hearing on the appeal of Docket 8078 has been scheduled for August 1994. While the Company believes that the Texas District Court will uphold the Texas Commission's orders, the ultimate outcomes of the appeals and their results or the materiality thereof cannot be predicted with certainty at this time.

Performance Standards for Palo Verde. In 1991, the Texas Commission established performance standards in Docket 8892 for the operation of the Palo Verde units. Each Palo Verde unit included in Texas rates is evaluated annually to determine if its three-year rolling average capacity factor entitles the Company to a reward or a penalty. There are five performance bands based around a target capacity factor of 70%. Neither a penalty nor a reward would result from capacity factors from 62.5% to 77.5%. Capacity factors are calculated as the ratio of actual generation to maximum possible generation. If the capacity factor for any unit is 35% or less, the Texas Commission is required to initiate a proceeding to determine whether such unit should continue to be included in rate base.

The performance standards are effective as of the date each unit is included in Texas rates, which was April 22, 1988 for Units 1 and 2. In June 1993, the Company filed its third annual performance report with the Texas Commission. The Company incurred neither a penalty nor a reward for the 1993 report. The three-year capacity factor was 72.9% for Unit 1 and 75.2% for Unit 2. The Company expects the report to be filed with the Texas Commission in 1994 to reflect performance for Units 1 and 2 resulting in neither a penalty nor a reward, though the projected capacity factor for Unit 2 is projected to be only slightly above the point at which a penalty could be incurred.

Recovery of Fuel Expenses. The Company recovers fuel and purchased power costs from its Texas customers pursuant to a fixed fuel factor established by the Texas Commission. Fuel revenues collected under the fixed fuel factor must be periodically reconciled to costs allowed by the Texas Commission. The Company's last reconciliation, Docket 8588, was for the period August 1, 1985

through March 31, 1989, and involved over \$200 million in Texas fuel costs. The final order issued in 1990 required a refund of approximately \$7.1 million, plus interest, which the Company completed over a twelve-month period beginning in February 1991. The Company and the City of El Paso appealed the Texas Commission's order in Docket 8588 to the Texas District Court. On November 25, 1991, the Texas District Court entered judgment on the appeals, upholding the Texas Commission's order on all points except the Company's appeal of the treatment of certain purchased power capacity costs during 1985-86. With regard to those costs, totaling approximately \$4.2 million, the Texas District Court held that the Texas Commission erred in failing to justify adequately its decision not to allow the Company to recover such costs through its reconcilable fuel account. The Texas District Court remanded the case to the Texas Commission with instructions to reconsider the allowance of such costs. Both the Texas Commission and the City of El Paso appealed the Texas District Court's decision to the Court of Appeals. On March 10, 1993, the Court of Appeals affirmed the decision of the Texas District Court. On February 2, 1994, the Texas Supreme Court denied the applications for writ of error filed by the City of El Paso and the Texas Commission. The case will be remanded to the Texas Commission for a new hearing to address whether the Company should be allowed to include the purchased power capacity charges as reconcilable fuel costs and recover such costs. The ultimate outcome of this hearing cannot be predicted at this time.

On January 26, 1993, the Texas Commission adopted a new fuel rule allowing for adjustment of the fixed fuel factor every six months on a prescribed schedule and requiring reconciliation of fuel costs and revenues whenever three years of fuel data have accumulated. Under the new rule, both refunds and surcharges are allowed without changing the fixed fuel factor where the cumulative over- or under-recovered fuel balance, including interest, is greater than or equal to 4% of the estimated annual fuel costs adopted most recently by the Texas Commission. The Texas Commission is required to act on a petition to change a fixed fuel factor within sixty or ninety days, depending on whether a hearing is required. The Company is allowed under the prescribed schedule to petition for a change in its Texas fixed fuel factor in January and July of each year under the new rule.

Ratemaking Treatment of Federal Income Taxes. In a 1987 case involving an electric utility, the Texas Supreme Court determined that, under certain circumstances, it is appropriate to allow only "actual taxes incurred" for ratemaking purposes. The Court of Appeals has applied the Texas Supreme Court decision to another utility. *Public Utility Commission of Texas v. GTE-Southwest*, 833 S.W.2d 153 (Tex. App. - Austin 1992, writ granted). The Texas Supreme Court heard oral argument in that case in September 1993 and has not ruled yet.

Additionally, the Texas Commission has recently applied various forms of the "actual taxes incurred" methodology in rate proceedings involving other utilities. There is significant uncertainty as to the application of the methodology used in those proceedings. The Texas Commission historically had granted rates that included an income tax component based on a "stand alone basis" and on the utility's allowed return on equity. The Texas Commission has now altered this policy. The appeals related to Dockets 8363 and 9945 include claims that the Texas Commission failed to adhere to the "actual taxes incurred" methodology in setting the federal income tax expense component of the Company's rates. As a result, any remand of Dockets 7460, 8363, 9165 or 9945 to the Texas Commission could include a reconsideration of the respective federal income tax components, which were based on the "stand alone" methodology previously used by the Texas Commission.

Depending on the outcome of any such remand, the Company may be required to refund certain amounts collected in rates since 1988. The likelihood and amount of any refunds are uncertain at this time because the ultimate outcome of the pending appeals is unknown, and the Company cannot predict the result of any remand.

Texas Rates Proposed in the Plan of Reorganization. For a discussion of the rate path proposed as part of the Company's Plan, see "Bankruptcy Proceedings for Reorganization - Regulatory Aspects of the Plan and Merger - Proposed Texas Rate Treatment," above.

New Mexico Rate Matters

Rate Moderation Plan-Palo Verde. In 1987, the New Mexico Commission approved a stipulation in Case 2009 establishing a rate moderation plan, pursuant to which the New Mexico jurisdictional portion of the Company's interest in Unit 1 and one-third of Common Plant and approximately 83% of the lease payments on Unit 2 and the related Common Plant were phased-in to rates in three steps. After the third step of the phase-in, the plan froze New Mexico rates through December 31, 1994. The Company agreed that it will not request rate base or cost of service treatment, or other rate recognition, for Unit 3 and its related Common Plant.

The Company will be required to recover the New Mexico jurisdictional portion of the Company's investment in Unit 3 through off-system sales in the economy energy market. For several years, market prices for economy energy sales have not been at levels sufficient to recover the New Mexico portion of the Company's current operating expenses related to Unit 3, including decommissioning costs and lease payments. The Company expects these market prices to remain at such levels in the near term. The Company projects, however, that the market prices of economy energy ultimately will rise to a level sufficient to recover the New Mexico jurisdictional portion of the Company's investment in Unit 3 over the remaining life of the asset.

Performance Standards for Palo Verde. In 1986, the New Mexico Commission established performance standards in Case 1833 for the operation of the Palo Verde units. The entire station is evaluated annually to determine if its achieved capacity factor entitles the Company to a reward or a penalty. There are five performance bands based around a target capacity factor of 67.5%. Neither a penalty nor a reward would result from capacity factors from 60% to 75%. The capacity factor is calculated as the ratio of actual generation to maximum possible generation. Since Unit 3 is not in rate base for purposes of New Mexico rates, any penalty or reward calculated on a total station basis is limited to two-thirds of such penalty or reward. If the annual capacity factor is 35% or less, the New Mexico Commission is required to initiate a proceeding to reconsider the rate base treatment.

Annual Filing Requirements. Pursuant to the New Mexico Commission's order in Case 1833, the Company must make annual filings, at least through the term of the rate moderation plan, to reconcile fuel costs and establish the fixed fuel factor for New Mexico customers. An annual performance standards report is included in the fuel reconciliation and any resulting rewards or penalties are included in the establishment of a new fixed fuel factor, if a new factor is warranted. The Company has received an extension through March 31, 1994 to file its annual fuel reconciliation report for the period January 1, 1993 through December 31, 1993. The Company expects such report will result in a significantly higher fuel factor, including no reward or penalty under the performance standards. The new factor is proposed to be implemented in May 1994. The Company also has requested an extension to file a cost of service compliance report with the New Mexico Commission in June 1994.

Federal Energy Regulatory Commission Rate Matters

The majority of the Company's rates for wholesale power and transmission services are subject to regulation by the FERC. Sales of wholesale power subject to FERC regulation make up a significant portion, approximately 15% in 1993, of the Company's operating revenues. Although rates to wholesale customers require FERC approval, the Company and its wholesale customers generally have established such rates through negotiations, based on certain cost of service assumptions, subject to FERC acceptance of the negotiated rates.

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. The Company also provides contingent capacity of 50 MW to IID. The agreement generally provides for level sales prices over the life of the agreement, which were intended to recover fully the Company's projected costs, as well as a return. Because of the

levelized rate, such costs and return were anticipated to exceed revenues for a number of the early years of the agreement with a reciprocal effect in the later years of the agreement. The Company has accrued revenues under the terms of the agreement in the amounts of \$2.4 million, \$2.9 million, and \$4.9 million in 1993, 1992 and 1991, respectively. Such accrued amounts, which since the inception of the agreement aggregate \$32 million as of December 31, 1993, are recorded as a long-term contract receivable on the Company's balance sheets. Based on the contractual payments, recovery of the unbilled amounts should begin in 1995. The agreement also provides that the Company may seek increases in the sales price if sufficient evidence exists to determine that certain operating costs have increased above those used in determining the original sales price.

The Company has a firm power sales agreement with TNP, providing for sales to TNP in the amount of 79 MW in 1993 and 75 MW thereafter through 2002, subject to provisions in the agreement that allow a reduction to a minimum of 25 MW in the amount of demand on a yearly basis. TNP has provided the Company notice that it would take advantage of the provisions to reduce the contract demand to 25 MW for 1994 and 1995, while preserving its option to maintain or reduce its contract demand in subsequent years. Sales prices, which decline over the life of the agreement, are based on substantially the same scheduled and projected costs and return as the IID agreement discussed above.

Rate tariffs currently applicable to IID and TNP contain appropriate fuel and purchased power cost adjustment provisions designed to recover the Company's fuel and purchased power costs.

Other Wholesale Customers

The Company has a sales agreement to provide capacity and associated energy to CFE through the end of 1996. The sales will be at 150 MW during the summer months and 120 MW at other times of the year through the remaining term of the agreement. Pricing for the agreement includes an escalating capacity charge and recovery of energy costs at system-average costs plus third-party energy charges. To support the requirements of the agreement with CFE, the Company entered into a firm power purchase agreement with SPS for at least 50 MW during the term of the CFE contract.

Construction Program

The Company has no current plans to construct any new base load generating facilities through the year 2000. This, however, is subject to change depending on the the Company's continued ability to receive a full allotment of power from Palo Verde. For a discussion of the operations of Palo Verde, see Part 1, "Facilities, Palo Verde Station." Utility construction expenditures reflected in the table below consist primarily of expanding and updating the electric transmission and distribution systems and the cost of betterments and improvements relating to the Palo Verde Station. The Company's estimated cash construction costs for 1994 through 1997 set forth in the table below are approximately \$223 million. Actual costs may vary from the construction program estimates set forth below. Such estimates are reviewed and updated from time to time to reflect changed conditions.

	By Year (1) (In millions)		By Function (In millions)
1994	\$ 64	Production (1)	\$ 67
1995	53	Transmission	61
1996	47	Distribution	74
1997	59	General	21
Total	<u>\$ 223</u>	Total	<u>\$ 223</u>

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

Facilities

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

Palo Verde Station

As of the date it filed the bankruptcy petition, the Company owned or leased a 15.8% interest in each of 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 Palo Verde Participants 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. Palo Verde 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 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. The sales were to the Owner Trustee as trustee for the Owner Participants. Of the total sales price of approximately \$934.4 million, the Owner Participants paid approximately \$192 million. The balance of the sales price was obtained by the Owner Trustee securing debt financing through a pledge of its rights under the leasebacks to the Company and, with respect to Unit 3, a pledge of the undivided interest.

The Company's investment in Palo Verde, both directly and through the sale and leaseback transactions, has a material impact on the Company's financial position and results of operations. See Part II, Item 8, "Financial Statements and Supplementary Data – Notes B and E of Notes to Financial Statements." Accordingly, an analysis of this investment and related obligations has been a central issue in the Company's formulation of a reorganization plan. For a discussion of the proposed treatment of Palo Verde under the Plan, see "Bankruptcy Proceedings for Reorganization of the Company – Treatment of Palo Verde" above.

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 40 years, authorize APS, as operating agent for Palo Verde, to operate the three Palo Verde units at full power.

Water Supply. In connection with the construction and operation of Palo Verde, APS, as operating agent, has entered into contracts with certain municipalities granting APS the right to purchase effluent for cooling purposes at Palo Verde. A summons served on APS in early 1986 required all water claimants in the Lower Gila River Watershed in Arizona to assert any claims to water on or before January 20, 1987, in an action pending in Maricopa County Superior Court (In re The General Adjudication of All Rights to Use Water in the Gila River System and Source, Supreme Court Nos. WC-79-0001 through WC-79-0004 (Consolidated) [WC-1, WC-2, WC-3 and WC-4 (Consolidated)], Maricopa County Nos. W-1, W-2, W-3 and W-4 (Consolidated)]). Palo Verde is located within the geographic area subject to the summons, and the rights of the Palo Verde Participants, including the Company, to the use of groundwater and effluent at Palo Verde is potentially at issue in this action. APS, as project manager of Palo Verde, filed claims that dispute the court's jurisdiction over the Palo Verde Participants' groundwater rights and their contractual rights to effluent relating to Palo Verde and, alternatively, seek confirmation of such rights. On December 10, 1992, the Arizona

Supreme Court heard oral argument on certain issues in this matter that are pending on interlocutory appeal and, as a result, issues important to the Palo Verde claims have been remanded to the trial court for further action. No trial date has been set in this matter.

Although the foregoing matter remains subject to further evaluation, APS has advised the Company that APS expects that the described litigation will not have a materially adverse impact on the operation of 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 rating program for each nuclear incident is approximately \$79.2 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 \$37.6 million, with an annual payment limitation of approximately \$4.7 million.

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 \$2.7 billion, a substantial portion of which must first be applied to stabilization and 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.

Decommissioning. For information regarding the obligations of the Company to plan and fund, over the service life of Palo Verde, its share of the estimated costs to decommission Palo Verde, see Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations – Operational Challenges" and Item 8, "Financial Statements and Supplementary Data – Note E of Notes to Financial Statements." The Company is currently collecting a portion of decommissioning costs for its investment in Palo Verde Units 1 and 2 in all three jurisdictions, and for Unit 3 in its Texas and FERC jurisdictions. The Company must fund the decommissioning requirements for its New Mexico jurisdictional portion of Unit 3 through off-system sales of economy energy. Because the Company is under fixed price contracts with its FERC customers, the amount of decommissioning costs received in current rates is not sufficient to fund the FERC portion of the revised decommissioning costs and, therefore, the Company must fund this shortfall.

ANPP Participation Agreement. Pursuant to the ANPP Participation Agreement, each Palo Verde Participant is required to fund its proportionate share of operation and maintenance, capital and fuel costs of Palo Verde. The Company's total monthly share of these costs is approximately \$7 million. The Participation Agreement provides that if a Palo Verde Participant fails to meet its payment obligations, each non-defaulting Palo Verde Participant shall pay its proportionate share of the payments owed by the defaulting Palo Verde Participant. On February 13, 1992, the Bankruptcy Court approved a stipulation between the Company and APS, as the operating agent of Palo Verde, pursuant to which the Company agreed to pay its proportionate share of all Palo Verde invoices delivered to the Company after February 6, 1992. The Company agreed to make these payments until such time as an order is entered by the Bankruptcy Court, if ever, authorizing or directing the Company's rejection of the Participation Agreement governing the relationship among the Palo Verde Participants. The stipulation also specifies that approximately \$9.2 million of the Company's Palo Verde payment obligations are to be considered prepetition general unsecured claims of the other Palo Verde Participants. Pursuant to the Plan, the Company intends to assume the ANPP Participation Agreement and the other agreements related to the operation of Palo Verde. To accomplish this and to resolve pending issues related to the assumption of the agreements and cure of existing defaults, the Company and the other Palo Verde Participants have entered into a Cure and

Assumption Agreement that was approved by the Bankruptcy Court on November 19, 1993. The Cure and Assumption Agreement sets forth the mechanism by which the ANPP Participation Agreement and other operating agreements related to Palo Verde will be assumed as of the Effective Date. Pursuant to the agreement, the Company paid APS, as operating agent, the amount of the prepetition obligations and APS paid the Company amounts of prepetition refunds that had been withheld, subject to all of such amounts being returned in the event the Plan does not become effective. For a discussion of the issues related to assumption of the ANPP Participation Agreement, see "Bankruptcy Proceedings for Reorganization of the Company - Treatment of Palo Verde," above.

Steam Generator Tubes. APS is continuing its investigation and analysis of steam generator tube degradation experienced at the plant. The incidence was discovered following the rupture of a tube in one steam generator in Unit 2 on March 14, 1993. APS declared an "alert" at Unit 2 due to the rupture and took action to remove the unit from service. An alert is the next to the lowest of the four NRC emergency classifications at a nuclear power plant. The alert was terminated on March 15, 1993. Unit 2 began a regular refueling outage on March 19, 1993, which originally had been scheduled to begin March 20, 1993. The outage was extended to early September 1993 and expanded to encompass testing and inspection of tubes in the two steam generators in the unit. In reports to the NRC, APS indicated it determined the cause of the steam generator tube rupture to be due to intergranular attack/intergranular stress corrosion cracking ("IGA/IGSCC") and that several environmental and chemical factors contributed to the IGA/IGSCC. APS developed corrective actions designed to mitigate the effects of the factors that contribute to IGA/IGSCC. Unit 2 was returned to service in early September 1993 at a level of 85% power.

On January 8, 1994, APS removed Unit 2 from service to inspect and chemically clean the two steam generators in a mid-cycle outage. APS has completed the inspection and the cleaning and the available results of the inspection have revealed additional tube degradation of the type (axial cracking in upper bundle) previously found in the unit's steam generators. The inspection also revealed a more common type of tube degradation (circumferential cracking at tubesheet) that has occurred in similarly designed steam generators at other nuclear plants. Unit 2 was returned to service on March 22, 1994 and has achieved 85% power as of March 29, 1994.

In September 1993, APS removed Unit 1 from service for a regularly scheduled refueling outage, during which an expanded inspection of the unit's two steam generators was scheduled. APS has informed the NRC the inspection did not reveal the accelerated tube degradation of the type experienced in Unit 2, but that the inspection has revealed the more common type of degradation and cracking (circumferential cracking at tubesheet). APS identified probable causes of the degradation as well as preventive and corrective measures that can be taken. APS has operated Unit 1 at 85% power until late February 1994, when it increased power to 86%.

Unit 3 was removed from service from late November 1993 to December 26, 1993 for a mid-cycle outage during which APS inspected the unit's two steam generators. APS has informed the NRC that the inspection did not reveal the type of steam generator degradation experienced in Unit 2's steam generators; however, the inspection did reveal the more common type of steam generator tube degradation (circumferential cracking at tubesheet). Due to the foregoing, APS has operated Unit 3 at 85% power from September 1993 (other than during the mid-cycle inspection outage) until late February, when it increased power to 86%. Unit 3 entered a regularly scheduled refueling outage on March 19, 1994, which will include additional inspection and chemical cleaning of the steam generators.

As described above, APS has performed, and is continuing, certain actions related to the steam generators, including chemical cleaning, operating the units at reduced temperatures and, for some period, operating the units at 85-86% power. APS has proposed that, as a result of these corrective actions, all three units should be returned to 100% power by mid-1995 and one or more units might be returned to 100% power at some point during 1994. As a result of the extended Unit 2 outage during

1993, reduced power operations of each Unit beginning in September 1993 and the mid-cycle inspection of Unit 2 beginning in November 1993, the Company estimates it incurred additional fuel and purchased power costs aggregating approximately \$10 million in 1993. During 1994, the Company estimates that it will incur additional fuel and purchased power costs averaging approximately \$1 million for each month that the units are operated at 85-86% power.

Four Corners Project

The Company has an undivided 7% interest in Units 4 and 5 at Four Corners located in northwestern New Mexico. Each of the coalburning generating units has a 739 MW capability. For emergencies each unit is rated at 784 MW. Both units are located adjacent to a surface-mined supply of coal and are jointly owned by the Company, APS (which is the operating agent for Four Corners), TEP, PNM, Southern California Edison Company and Salt River Project Agricultural Improvement and Power District.

Pursuant to an agreement among the participants in Four Corners Units 4 and 5, each participant is required to fund its proportionate share of operation and maintenance, capital and fuel costs of Four Corners Units 4 and 5. The Company's total monthly share of these costs is approximately \$1.1 million. The agreement provides that if a participant fails to meet its payment obligations, each non-defaulting participant shall pay its proportionate share of the payments owed by the defaulting participant. The Company has been paying operating and maintenance, capital and fuel costs related to Four Corners incurred after the date of the Company's bankruptcy petition, but has not paid any amounts incurred prepetition. In December 1992, the Company filed a motion in the Bankruptcy Court to assume all of the contracts related to Four Corners. The Motion has not yet been acted on by the Bankruptcy Court. If the motion is approved by the Bankruptcy Court, the Company would be obligated to pay the prepetition claims related to such contracts, which approximate \$1.2 million.

The Four Corners Plant is located on land held under easements from the federal government and also under a lease from the Navajo Nation. Certain of the transmission lines and almost all of the contracted coal sources for the Four Corners Plant are also located on Navajo land.

The participants in Four Corners are among the defendants in a suit filed by the State of New Mexico in March 1975 in state district court in New Mexico against the United States of America, the City of Farmington, New Mexico, the Secretary of the Interior as Trustee for the Navajo Nation and other Indian tribes and certain other defendants (State of New Mexico ex rel. New Mexico State Engineer v. United States of America, et al., San Juan District Court, Cause No. 75-184). The suit seeks adjudication of the water rights of the San Juan River Stream System in New Mexico, which, among other things, supplies the water used at Four Corners. No trial date has been set in this matter and the case has been inactive for some time. An agreement reached with the Navajo Nation in 1985, however, provides that if Four Corners loses a portion of its rights in the adjudication, the Navajo Nation will provide, at a cost to be determined at that time, sufficient water from its allocation to offset the loss.

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 primarily operate on intrastate natural gas, but also are capable of operating on interstate natural gas and fuel oil. See "Energy Sources-Natural Gas."

Rio Grande Power Station

The Rio Grande Power Station, located in Sunland Park, New Mexico, adjacent to El Paso, Texas, consists of three steam-electric generating units which have an aggregate capability of 246 MW when operating entirely on natural gas. The units operate primarily on interstate natural gas, but are also capable of operating on fuel oil. See "Energy Sources—Natural Gas."

Copper Power Station

The Copper Power Station, located in El Paso, Texas, consists of a 69 MW combustion turbine capable of operating on fuel oil or natural gas and is used for peaking purposes. The combustion turbine and other generation equipment at the station were sold and leased-back by the Company in 1980 pursuant to a twenty-year lease with an option to renew of up to seven years. Such lease is subject to review as an executory contract and may be assumed or rejected by the Company in the course of its bankruptcy proceedings. In December 1992, the Company filed a motion with the Bankruptcy Court to assume all of the agreements related to the sale and leaseback. The motion has not been ruled upon as of the current date. See "Bankruptcy Proceedings for Reorganization of the Company." The station operates primarily on intrastate natural gas, but also is capable of operating on fuel oil. See "Energy Sources—Natural Gas."

Transmission Lines

The Company owns the following facilities:

1. A 310-mile, 345 KV transmission line from TEP's Springerville Generating Plant near Springerville, Arizona, to the Luna Substation near Deming, New Mexico, to the Diablo Substation near Sunland Park, New Mexico. This line is known as the Arizona Interconnection Project (AIP) and provides an interconnection with TEP for delivery of the Company's generation entitlements from Palo Verde and Four Corners. The AIP also enables the Company to import low cost energy from the Arizona/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.
2. A 202-mile, 345 KV transmission line from the Arroyo Substation, located near Las Cruces, New Mexico, to PNM's West Mesa Substation located near Albuquerque, New Mexico. This line provides the Company's primary interconnection with PNM over which the Company's Four Corners entitlement is delivered. This entitlement is delivered from Four Corners to West Mesa over PNM's 345 KV and 230 KV transmission system in northern New Mexico. Additionally, through the Company's interconnection with PNM, the Company has a major interconnection with the other five participants in Four Corners, plus access to power the Company obtains from the economy markets west and north of Four Corners.
3. Undivided interests in a 196-mile, 345 KV transmission line from the Newman Power Station across southwestern New Mexico, to TEP's Greenlee Substation in Arizona. Specifically, the Company owns an undivided 40% interest in the 60-mile, 345 KV line between TEP's Greenlee Substation and the Hidalgo Substation near Lordsburg, New Mexico; an undivided 57.2% interest in the 50-mile, 345 KV line between the Hidalgo Substation and the Luna Substation near Deming, New Mexico; and a 100% interest in the 86-mile, 345 KV line between the Luna Substation and the Newman Power Station. This line provides an interconnection with TEP for delivery of the Company's entitlements from Four Corners and Palo Verde, as well as providing added stability, flexibility and reliability to the Company's system.
4. An undivided 66.67% interest in a 125-mile, 345 KV transmission line between the AMRAD Substation near Oro Grande, New Mexico, and SPS's Eddy County Substation near Artesia,

New Mexico. This line terminates at a high-voltage direct current (HVDC) converter facility connected with SPS, providing the Company with access to the Southwestern Power Pool power market.

Environmental Matters

The Company is subject to regulation with respect to air, soil and water quality, solid waste disposal and other environmental matters by federal, state and local authorities. These authorities govern current facility operations and exercise continuing jurisdiction over facility modifications. Environmental regulations can change at a rapid pace and cannot be predicted with certainty. The construction of new facilities is subject to standards imposed by environmental regulation and substantial expenditures may be required to comply with such regulations. Recognition in rates of the capital expenditures and operating costs incurred in response to environmental considerations will be subject to normal regulatory review and standards. The Company analyzes the costs of its obligations arising from environmental matters on an on-going basis and believes it has made adequate provision in its financial statements to meet such obligations.

Clean Air Act. In November 1990, the Clean Air Act Amendments of 1990 (the "Clean Air Act") became law. The Clean Air Act establishes new regulatory and permitting programs that will be administered by EPA or delegated to state agencies. Many provisions of the Clean Air Act will affect operations by electric utilities, including the Company. In particular, the following areas addressed in the Clean Air Act may have a significant impact on the Company: Title I dealing with nonattainment of national air ambient quality standards, Title IV dealing with acid rain, and Title V covering operating permits. In addition, provisions addressing mobile sources of pollutants and hazardous air pollutants may have a lesser impact on the Company's operations.

The Company has completed an initial evaluation of the impact of the Clean Air Act on the Company's operations and has developed a five-year plan beginning in 1993 to implement Clean Air Act requirements on existing facilities. As part of the plan, the Company will make modifications to existing facilities at the Newman Power Station and the Rio Grande Power Station, including modifications to the steam generators and combustion turbines and the installation of continuous emissions monitoring equipment. The projected costs of these capital improvements are approximately \$5 million over the five-year period of the plan.

Rio Grande Power Station. The Company has notified NMED of a spill of approximately 510 barrels of fuel oil which occurred at the Rio Grande Power Station in August 1986. The initial site assessment has been completed, a remediation plan has been submitted to NMED, and remediation is progressing under the plan. Potential clean-up costs are currently estimated to be less than \$500,000 to be incurred over the next five to ten years. The New Mexico Water Quality Act provides for a potential penalty of \$1,000 for each day of violation, which for a five-year period could result in a penalty of approximately \$2 million. The Company has been in close communication with the NMED and does not believe that a penalty of such magnitude will be assessed. The NMED has filed a proof of claim in the Bankruptcy Case reflecting an alleged obligation in an unspecified sum based on alleged ground water or soil contamination at the Rio Grande Power Station.

COL-TEX Refinery Site. In November 1991, the Company was notified by the TNRCC that the Company had been identified as a potentially responsible party ("PRP") at the Col-Tex Refinery Texas Superfund Site in Colorado City, Mitchell County, Texas (the "Col-Tex Site"). The Col-Tex Site consists of approximately 25 acres located along the Colorado River immediately west of Colorado City, Texas. The Col-Tex Site was the location of several oil refining companies that owned and/or operated at the Col-Tex Site from the 1920s to the late 1960s.

The State of Texas, on behalf of the TNRCC, filed a proof of claim in the Company's Bankruptcy Case for remediation and oversight costs and requested that the claim be accorded administrative

expense priority designation. The TNRCC's position is that the Company is a PRP and is, therefore, jointly and severally liable for the full cost of clean-up and oversight at the Col-Tex Site. The TNRCC has informed the Company informally that it estimates site assessment costs to be approximately \$3 million and the total clean-up costs to be approximately \$22 million. The Company disputes that it is liable as a PRP under applicable law. Accordingly, the Company has not agreed to participate in the assessment and remediation of the Col-Tex Site.

The Company also received notice on January 12, 1993 of the State's review of liability in connection with an expansion of the Col-Tex Site to an area referred to as Col-Tex II. The Company has been identified as a PRP in connection with this expanded site, but its position with respect to liability there is consistent with its position with respect to the Col-Tex Site.

The following entities have filed proofs of claim in the Bankruptcy Case related to potential claims for contribution in the event any of such entities has liability for remediation and oversight costs of the Col-Tex Site: ASARCO, Inc., Tesoro Petroleum Company, Fina Oil & Chemical Company and Missouri Pacific Railroad Company.

On November 24, 1993, a Joint Motion for Order Approving the Withdrawal of Proofs of Claim filed by the State of Texas was filed in the Bankruptcy Case by attorneys for the Company and the State of Texas. Fina Oil & Chemical Company filed an objection to the motion and, at this time, no action has been taken by the Bankruptcy Court.

Energy Sources

General

The following table lists the percentage contribution of coal, gas, uranium, and purchased power to the total energy mix of the Company.

	<u>Uranium</u>	<u>Gas</u>	<u>Coal</u>	<u>Purchased Power</u>
1991	53%	29%	10%	8%
1992	51	31	10	8
1993	43	29	10	18

For a discussion of the recovery by the Company of its fuel costs, see "Regulation — Texas Rate Matters — Recovery of Fuel Expenses," "Regulation — New Mexico Rate Matters — Annual Filing Requirements," and "Regulation — Federal Energy Regulatory Commission Rate Matters."

Nuclear Fuel

Nuclear Fuel Cycle. The fuel cycle for Palo Verde is comprised of the following stages: (i) the mining and milling of uranium ore to produce uranium concentrates; (ii) the conversion of uranium concentrates to uranium hexafluoride; (iii) the enrichment of uranium hexafluoride; (iv) the fabrication of fuel assemblies; (v) the utilization of fuel assemblies in reactors; and (vi) the storage of spent fuel and the disposal thereof. The Palo Verde Participants, including the Company, have made arrangements through contract flexibilities to obtain quantities of uranium concentrate anticipated to be sufficient to meet operational requirements through 1996. Existing contract options could be utilized to meet approximately 50% of requirements from 1997 through 1999 and 30% of requirements for 2000 through 2002. Spot purchases in the uranium market will be made, as appropriate, in lieu of any uranium that might be obtained through contract flexibilities and options. The Palo Verde Participants, including the Company, have contracted for all conversion services required through 1994 and for up to 65% of conversion services required through 1998, with options to continue through

the year 2000. The Palo Verde Participants, including the Company, have an enrichment services contract with DOE which 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 annual options to terminate each year of the contract with ten years prior notice. In view of other alternatives, the Palo Verde Participants have exercised this option, terminating 30% of requirements for 1996 through 1998 and 100% of requirements during the years 1999 through 2002. Purchasers of enrichment services from the DOE are assessed for the costs of the decontamination and decommissioning of DOE enrichment facilities pursuant to provisions of the Energy Policy Act of 1992. Existing contracts will provide fuel assembly fabrication services for at least ten years from the operation date of each Palo Verde unit and, through contract options, approximately fifteen additional years are available.

Spent fuel storage facilities at Palo Verde have sufficient capacity with certain modifications to store all fuel expected to be discharged from normal operation of all of the Palo Verde units through at least the year 2005. Pursuant to the Nuclear Waste Policy Act of 1982, as amended in 1987 (the "Waste 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 Waste 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, including the Company, has executed a spent fuel disposal contract with DOE. The Waste 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's spent fuel shipments to the DOE permanent disposal facility would begin in approximately 2025. In addition, APS has indicated that on-site storage of spent fuel may be required beyond the life of Palo Verde's generating units. APS also has indicated that alternative interim spent fuel storage methods will be available on-site or off-site for use by Palo Verde to allow its continued operation beyond 2005 and to store spent fuel safely until DOE's scheduled shipments from Palo Verde begin.

Nuclear Fuel Financing. Pursuant to the ANPP Participation Agreement, 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 for the purpose of financing the Company's purchases of nuclear fuel. Prior to the filing of the Company's bankruptcy petition, the trust generally financed nuclear fuel and all costs in connection with the acquisition of the Company's share of nuclear fuel for use at Palo Verde up to \$125 million pursuant to a borrowing facility that is supported by a letter of credit. The Company had the option of either paying for the fuel from the trust at the time the fuel was loaded into the reactor or paying for the fuel at the time heat was generated by the fuel. Prior to the petition date of the Bankruptcy Case, the Company elected to pay for the fuel as the heat was produced from the fuel. Since the Company filed its bankruptcy petition, the Company has not sought to finance its fuel costs from the trust, but has instead paid for nuclear fuel with internally generated funds.

The trust has filed a proof of claim in the Bankruptcy Case, alleging an unliquidated prepetition amount owed by the Company to it of not less than approximately \$70.9 million, plus an additional unliquidated amount for postpetition interest on the obligation and other fees and costs, plus an additional unliquidated amount for fuel consumed by the Company after the petition date (which amount the trust asserts is an administrative expense claim). The trust also has filed a proof of claim in the Bankruptcy Case based on a related note payable to the trust, alleging an unsecured prepetition claim of approximately \$9.9 million. The trust contends that it has an enforceable property interest in Palo Verde nuclear fuel, power, energy and revenues, which the Company is disputing in the Bankruptcy Case. The trust and the Company entered into an interim adequate protection order in the Bankruptcy Case, which essentially preserves the rights, positions and arguments of each party, but does not resolve disputes as to the trust's claims and interests in property. For a discussion of the

resolution of the disputes and the treatment of the trust's claim under the Plan, see "Bankruptcy Proceedings for Reorganization of the Company — Treatment of Claims Under the Plan," above.

Natural Gas

In 1993, the Company's interstate natural gas requirements at the Rio Grande Power Station were met solely with spot natural gas purchases from various suppliers. The Company's interstate gas is transported under a firm gas transportation agreement, which became effective September 1, 1991 and expires in 2001. Based on the current availability of abundant, economic and reliable spot natural gas, the Company anticipates it will continue to purchase spot natural gas for the Rio Grande Power Station for the near term. For the long term, the Company will evaluate the continued availability of spot natural gas versus other supplies in obtaining a reliable and economical supply for the Rio Grande Power Station.

The intrastate natural gas requirements for the Newman Power Station and the Copper Power Station are supplied and transported pursuant to an intrastate natural gas contract with Meridian Oil Transportation ("MoTrans"), which is effective through December 31, 1995. Prior to the contract expiring in 1995, the Company will evaluate a continued relationship with MoTrans versus other suppliers to ensure the continued supply of reliable and economic natural gas for the Newman Power Station and the Copper Power Station.

The Company's agreements to purchase natural gas are generally executory contracts subject to assumption or rejection in the Bankruptcy Case. The Company has filed a statement with the Bankruptcy Court indicating that it intends to assume the MoTrans Agreement on the Effective Date.

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 Navajo Nation. In 1993, the prices paid for coal were relatively stable, although applicable contract clauses permit escalations under certain conditions. In addition, major price changes from time to time result from contract renegotiation. APS, as operating agent for Four Corners, entered into an incentive coal price agreement on behalf of the Four Corners Participants effective November 1991 and continuing through 1994 providing for price reductions on amounts of coal purchased in excess of a set base amount.

Executive Officers of the Company

<u>Name</u>	<u>Age</u>	<u>Current Position and Business Experience</u>
David H. Wiggs, Jr.	46	Chairman of the Board since May 1989; Chief Executive Officer since March 1989; Director since January 1988; President from January 1988 to January 1994.
Curtis L. Hoskins	56	Director since April 1992; President since January 1994; Chief Operating Officer since May 1990; Executive Vice President from May 1990 to January 1994; Executive Vice President, Utah Power & Light Company, Salt Lake City, Utah, for more than five years prior to April 1989.
Eduardo A. Rodriguez	38	Senior Vice President since January 1994; Vice President from April 1992 to January 1994; Secretary from January 1989 to January 1994; General Counsel since 1988.
J. Frank Bates	44	Vice President - Customer Services since June 1989; Assistant Vice President - Customer Services from November 1987 to June 1989.
John E. Droubay	55	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	41	Controller and Chief Accounting Officer since September 1989; for more than 6 years prior thereto, partner or member, Coopers & Lybrand (certified public accountants).
Gary R. Hedrick	39	Vice President - Financial Planning and Rate Administration since September 1990; Treasurer from 1988 to September 1990; Assistant Vice President, Finance from February 1990 to September 1990.
John C. Horne	45	Vice President - Transmission Systems Division since August 1989; Group Manager - Transmission and Distribution from November 1987 to August 1989.
Robert C. McNeil	47	Vice President - New Mexico Division since December 1989; Assistant Vice President - New Mexico Division from July 1989 to December 1989; Manager - Energy Marketing from 1988 to July 1989.

<u>Name</u>	<u>Age</u>	<u>Current Position and Business Experience</u>
James A. Mayhew	39	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 for more than one year prior to June 1989.
Guillermo Silva, Jr.	41	Secretary since January 1994, Assistant Secretary from June 1989 to January 1994; and other supervisory positions with the Company for more than one year prior to June 1989.

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

	<u>December 31,</u>		
	<u>1993</u>	<u>1992</u>	<u>1991</u>
Operating Revenues (In thousands):			
Retail:			
Residential	\$ 147,966	\$ 144,059	\$ 130,260
Commercial and industrial, small	147,418	142,133	127,504
Commercial and industrial, large	50,516	51,108	47,931
Sales to public authorities	74,611	72,039	65,625
Provision for refund		(646)	46
Other	(8,152)	309	3,023
	<u>412,359</u>	<u>409,002</u>	<u>374,389</u>
Wholesale:			
Sales for resale	128,157	110,776	75,443
Economy sales	3,078	4,982	12,573
Total operating revenues	<u>\$ 543,594</u>	<u>\$ 524,760</u>	<u>\$ 462,406</u>
Number of customers (End of year):			
Residential	235,151	228,688	223,684
Commercial and industrial, small	23,338	22,883	22,417
Commercial and industrial, large	74	68	68
Other	3,395	3,251	3,156
Total	<u>261,958</u>	<u>254,890</u>	<u>249,325</u>
Average annual use and revenue per residential customer:			
KWH	6,142	6,169	6,063
Revenue	<u>\$ 637.68</u>	<u>\$ 636.93</u>	<u>\$ 588.11</u>
Average revenue per KWH:			
Residential	10.38¢	10.32¢	9.70¢
Commercial and industrial, small	9.12	9.14	8.44
Commercial and industrial, large	5.79	5.61	5.55
Energy supplied, net, KWH (In thousands):			
Generated	6,625,162	7,330,004	6,128,171
Purchased and interchanged	1,416,172	589,288	1,273,440
Total	<u>8,041,334</u>	<u>7,919,292</u>	<u>7,401,611</u>
Energy sales, KWH (In thousands):			
Retail:			
Residential	1,424,935	1,395,387	1,342,830
Commercial and industrial, small	1,616,434	1,555,047	1,511,550
Commercial and industrial, large	872,477	911,750	864,025
Sales to public authorities	1,034,231	997,483	956,691
	<u>4,948,677</u>	<u>4,859,667</u>	<u>4,675,096</u>
Wholesale:			
Sales for resale	2,484,128	2,361,204	1,717,850
Economy sales	164,559	264,654	637,425
Total sales	<u>7,596,764</u>	<u>7,485,525</u>	<u>7,030,371</u>
Losses and company use	444,570	433,767	371,240
Total	<u>8,041,334</u>	<u>7,919,292</u>	<u>7,401,611</u>
Native system:			
Peak load, KW	997,000	974,000	929,000
Net generating capacity for peak, KW	1,497,000	1,497,000	1,497,000
Load factor	62.1%	62.3%	62.6%
Total system:			
Peak load, KW	1,335,000	1,302,000	1,142,000
Net generating capacity for peak, KW	1,497,000	1,497,000	1,497,000
Load factor	66.4%	66.4%	67.9%

Item 2. Properties

The principal properties of the Company are described in Item 1, "Business," 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. See Part II, Item 8, "Financial Statements and Supplementary Data—Note H of Notes to Financial Statements" for information regarding encumbrances against the principal properties of the Company.

Item 3. Legal Proceedings

Automatic Stay of Litigation Due to Bankruptcy

Upon the filing of the Company's bankruptcy petition, the provisions of the Bankruptcy Code operate as a stay applicable to all entities of, among other things, the commencement or continuation of judicial, administrative, or other actions or proceedings against the Company that were or could have been commenced before the bankruptcy petition was filed. This stay is subject to certain exceptions—criminal actions and actions by governmental units to enforce police or regulatory powers, for example, are not stayed. The Bankruptcy Court also has discretion to terminate, annul, modify or condition the stay.

P & C Lacelaw Trust Litigation

In September 1990, P & C Lacelaw Trust ("Lacelaw") filed suit in the 346th District Court of El Paso County, Texas, Cause No. 90-10139, against the Company, Franklin, and DDG, Inc. ("DDG"), the company that 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 allegedly 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 (i) a declaratory judgment that the Company is a general partner in the partnership; (ii) a judgment declaring Lacelaw's rights as a limited partner; (iii) an accounting of all financial transactions involving the partnership; and (iv) a dissolution of the partnership. Lacelaw alleges actual damages of \$3.2 million and punitive damages of at least \$10 million. The Company vigorously denies any liability with respect to this lawsuit and believes that the claims are without merit. Because of the automatic stay imposed as a result of the Company's bankruptcy filing, 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. Lacelaw has filed a proof of claim in the Bankruptcy Case asserting a general unsecured claim in excess of \$3 million based on the litigation, but has not attempted to lift the stay.

Plains Electric Generation and Transmission Cooperative Litigation

On December 12, 1991, Plains Electric Generation and Transmission Cooperative, Inc. ("Plains") filed suit in the United States District Court for the District of New Mexico, Cause No. CIV91-1199, against the Company alleging breach of a letter of understanding related to a potential option to purchase up to 50 MW of transfer capability in the AIP if certain enhancements could be made to the AIP to allow additional transfer capability. Plains seeks specific performance or, alternatively, compensatory and punitive damages in an unspecified amount for breach of contract, breach of implied covenant of good faith and fair dealing, breach of the New Mexico Unfair Practices Act, and tortious conduct for not performing the terms of the letter of understanding. The Company filed an answer and counterclaim to the action on January 6, 1992, denying all allegations and asserting that any dispute should be subject to arbitration. The Company denies any liability with respect to the lawsuit and

intends to defend the action vigorously. Due to the automatic stay imposed as a result of the bankruptcy filing, no discovery has been conducted in this case; therefore, the outcome of the suit and potential damages, if any, cannot be determined at this time. Plains has filed a proof of claim in the Bankruptcy Case for an unliquidated amount. The letter of understanding may or may not be an executory agreement that is subject to assumption or rejection under the Bankruptcy Code.

Tax Matters

Federal Tax Matters. The IRS filed a second revised proof of claim on February 22, 1993 in the amount of approximately \$53.7 million, consisting of approximately \$12.2 million of additional taxes to be owed for the tax years 1983 through 1989, approximately \$24.7 million of interest thereon through the filing date of the bankruptcy petition, and approximately \$16.8 million in penalties. The proof of claim is based on two examinations conducted by the IRS that are pending at the administrative appeals level within the IRS. On March 28, 1994, the Company filed a motion and form of agreed order with the Bankruptcy Court to seek approval of a settlement of the claims of the IRS in the Bankruptcy Case in the amount of approximately \$6.5 million, including interest. Under the terms of the proposed settlement, the Company has requested approval from the Bankruptcy Court to pay the IRS currently rather than at the effective date of a plan of reorganization and the IRS has agreed to reduce the claim by 5%, to approximately \$6.2 million. The Company believes, but can give no assurance, that the Bankruptcy Court will approve the terms of the settlement. The Company has made adequate provisions for the claim in its financial statements.

Arizona Transaction Privilege ("Sales") Tax. The ADR conducted an audit of the sales taxes paid on lease payments under the Palo Verde Leases during the audit period of August 1, 1988 through July 31, 1990. On March 10, 1992, the Company received copies of Notices of Proposed Assessment (the "Sales Tax Notices") issued by the ADR to each of the taxpayer owner trusts in care of the Owner Trustee. The original proposed total deficiency assessments, which covered only the audit period, were approximately \$8.8 million, plus related interest thereon. On February 22, 1993, the ADR filed Notices of Jeopardy Assessment totaling approximately \$7.8 million, including interest through February 28, 1993, to convert the proposed deficiencies for the audit period into jeopardy assessments, which are immediately collectible. On February 23, 1993 the ADR filed Notices of Tax Lien in the Maricopa County Recorder's Office and with the Secretary of State of Arizona against the owner trusts' interests in Palo Verde. Under the Arizona tax statutes, the owner trusts can contest both the jeopardy assessment and the underlying assessment. Although the ADR can take action immediately to collect the alleged deficiency from the owner trusts, including collection action and foreclosure on the owner trusts' interests in Palo Verde, the ADR has taken no action in that regard. The ADR also may assert additional tax deficiencies for the period from August 1, 1990 through 1991, when the last lease payments were received by the owner trusts. The Owner Participants have informed the Company that the ADR has scheduled a hearing on April 11, 1994.

If the Owner Trustee or Owner Participants incur additional tax liability or other loss as a result of the assessments, the Owner Trustee and Owner Participants may have a claim against the Company for indemnification pursuant to the participation agreements and leases in the sale and leaseback transactions. The Owner Trustee and Owner Participants have filed proofs of claim alleging unliquidated amounts owed pursuant to the participation agreements and leases, which may encompass claims for indemnification. Pursuant to the settlement agreements entered into between the Company, the Owner Trustee and each Owner Participant in connection with the Plan, the Company's indemnity obligations under the participation agreements generally would continue in effect following the Effective Date, including any claim for indemnification as a result of this matter. For a discussion of the settlement agreements, see "Bankruptcy Proceedings for Reorganization of the Company — Treatment of Palo Verde," above. If the Owner Trustee fails to contest the jeopardy assessment or the underlying assessment, the Company would challenge the amount of any indemnification claim. The Company cannot predict the outcome of the underlying tax dispute or any claim for indemnification arising out of this matter.

Other Legal Proceedings

Information regarding legal proceedings relating to the Company's bankruptcy filing, Palo Verde, Four Corners, rates and regulation and environmental matters is included under the subcaptions "Bankruptcy Proceedings for Reorganization of the Company," "Regulation," "Facilities" and "Environmental Matters" under "Business" in Item 1 and is incorporated herein by reference.

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 on The NASDAQ Stock Market. The Company's NASDAQ symbol for its common stock changed from "ELPA" to "ELPAQ" to indicate that the Company is the subject of bankruptcy proceedings. Under the terms of the Company's listing agreement with the NASD and the bylaws of the NASD, the NASD may, as a result of the Company's Chapter 11 bankruptcy filing, apply additional or more stringent criteria for continued inclusion of the Company's common stock in the NASDAQ system or suspend or terminate the stock's inclusion in NASDAQ. In addition, because the Company does not meet certain net worth requirements set forth in Schedule D to the bylaws of the NASD, the NASD may delist the Company's common stock from NASDAQ. The NASD has not informed the Company of any current intention to implement any of the aforementioned measures. For a description of the treatment of common stock interests under the Plan, see Part I, Item 1, "Business - Bankruptcy Proceedings for Reorganization of the Company - Consideration to Shareholders Pursuant to the Plan and Merger Agreement."

The Company has paid no dividends on shares of its common stock since March 1989. The high and low per share sale prices for the Company's common stock, as reported by NASDAQ, for the periods during 1993 and 1992 indicated below, were as follows:

	<u>Sale Price</u>	
	<u>High</u>	<u>Low</u>
<u>1993</u>		
First Quarter	\$ 35/8	\$ 2
Second Quarter	33/8	2
Third Quarter	33/16	27/16
Fourth Quarter	27/8	2 1/2
<u>1992</u>		
First Quarter	\$ 43/4	\$ 2 1/4
Second Quarter	37/8	3
Third Quarter	3 1/2	27/8
Fourth Quarter	3	2 1/8

At March 16, 1994, there were approximately 24,447 holders of record of the Company's common stock.

The Board of Directors voted to suspend payment of dividends and mandatory sinking fund payments on the Company's outstanding cumulative preferred stock commencing with dividend and redemption payments due October 1, 1991. Such suspension has continued through the date of this report. See Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources - Preferred Stock Dividends and Sinking Fund Payments." The Company cannot predict when the preferred stock dividends and sinking fund payments will be resumed, but such payments are precluded by the Bankruptcy Code during the Bankruptcy Case. For a description of the proposed treatment of the preferred stock interests under the Plan, see Part I, Item 1 "Business - Bankruptcy Proceedings for Reorganization of the Company - Consideration to Shareholders Pursuant to the Plan and Merger Agreement."

Under the Company's articles of incorporation, as of July 1, 1992, the holders of preferred stock have the right (subject to satisfaction of certain procedural requirements) to elect two additional directors to the Board of Directors. This right has accrued because dividends on the outstanding preferred stock have accumulated and remained unpaid in a cumulative amount at least equal to four

quarterly dividends. If preferred stock dividends in an amount equal to twelve full quarterly dividends are unpaid, the holders of the preferred stock will be entitled to elect the smallest number of directors necessary to constitute a majority of the full Board of Directors until all dividends of preferred stock have been fully paid. Under the Plan, by voting in favor of the Plan, the preferred shareholders have waived any right to elect a majority of the Board of Directors under the Company's articles of incorporation.

The Company has not received notice of any preferred shareholder's desire or intent to exercise the right to elect two additional directors and cannot predict whether or when any such action might be taken. The PUHCA defines a "holding company" as, among other things and except as therein provided, (i) any company that directly or indirectly owns, controls or holds with power to vote 10% or more of the outstanding "voting securities" of a public utility company or another "holding company;" or (ii) any person or company which the SEC determines, directly or indirectly, to exercise (either alone or pursuant to an arrangement or understanding with one or more persons) such a controlling influence over the management or policies of any public utility as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such person or company be subject to the regulation of the PUHCA. A "voting security" is defined as, among other things, any security presently entitling the owner or holder thereof to vote in the direction or management of the affairs of a company. Previously, the shares of the Company's common stock were the only "voting securities" outstanding. Now that the holders of the Company's preferred stock have the voting rights described in the preceding paragraph, shares of the preferred stock also may constitute "voting securities" under the PUHCA. Holders of significant positions in the preferred stock (if such shares constitute "voting securities" under the PUHCA) and/or in the common stock could, depending on the circumstances, be deemed to be "holding companies." Any holder so deemed to be a "holding company" would, subject to certain exceptions, be required to register as such under the PUHCA and, if such registration were required, such holder, as well as the Company, would become subject to extensive regulation under the PUHCA.

Item 6. Selected Financial Data

As of and for the years ended December 31:

	<u>1993</u>	<u>1992</u>	<u>1991</u> (In thousands except per share data)	<u>1990</u>	<u>1989</u>
Operating revenues	\$ 543,594	\$ 524,760	\$ 462,405	\$ 445,309	\$ 433,470
Operating income	64,971	67,036	50,722	44,799	56,511
Income (loss) from continuing operations before extraordinary item and cumulative effect of a change in accounting principle	(41,855)	(28,180)	(266,912) ⁽¹⁾	(21,864)	1,956
Extraordinary item	—	—	(289,102) ⁽²⁾	—	—
Cumulative effect of a change in accounting principle	(96,044) ⁽³⁾	—	—	—	—
Net loss per weighted average share of common stock:					
Loss before extraordinary item and cumulative effect of a change in accounting principle	(1.18)	(0.79)	(7.75) ⁽¹⁾	(0.96)	(0.28)
Extraordinary item	—	—	(8.14) ⁽²⁾	—	—
Cumulative effect of a change in accounting principle	(2.70) ⁽³⁾	—	—	—	—
Dividends declared per share of common stock	—	—	—	—	0.38
Total assets	1,715,406	1,702,778 ⁽⁴⁾	1,566,281 ⁽⁵⁾	1,901,928	1,808,802
Additions to utility plant, before allowance for equity funds used for construction ...	58,215	60,570	63,394	80,139	143,956
Obligations subject to compromise	1,495,315	1,440,968	—	—	—
Debt in default	—	—	1,286,703	—	—
Long-term financing and capital lease obligations	—	—	—	798,111	755,761
Preferred stock - redemption required	67,266 ⁽⁶⁾	67,266 ⁽⁶⁾	67,266 ⁽⁶⁾	79,360	100,710
Common stock equity (deficit) ...	<u>(357,463)</u>	<u>(220,508)</u>	<u>(191,434)</u>	<u>371,690</u>	<u>404,309</u>

(1) Includes approximately \$221.1 million after-tax loss attributable to letters of credit draws and approximately \$25.2 million after-tax write-off primarily for regulatory disallowance in Texas Docket 9945.

(2) Reflects the after-tax effect resulting from the discontinuance of the application of SFAS No. 71.

(3) Reflects the change in accounting for income taxes due to the implementation of SFAS No. 109.

(4) Increase from 1991 primarily is due to increase in cash and temporary investment which results from the nonpayment of interest and Palo Verde lease costs.

(5) Decrease from 1990 primarily is due to the write-off of regulatory assets.

(6) Includes approximately \$3.3 million of dividends in arrears.

The selected financial data should be read in conjunction with Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," and Item 8, "Financial Statements and Supplementary Data," below.

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

Liquidity and Capital Resources

Overview

The Company filed a petition under Chapter 11 of the Bankruptcy Code on January 8, 1992 and has continued operations as debtor-in-possession. For a number of years prior to the petition filing, the Company was dependent on external financing through the capital markets for liquidity needs. As a result of the filing of the bankruptcy case and related cessation or limitation of payments on certain of the Company's financial arrangements, the Company generated sufficient funds internally to meet its liquidity needs in 1992 and 1993. At December 31, 1993, the Company had a balance of approximately \$181 million in cash or cash equivalents.

The Company has paid interest at contractual non-default rates on its First and Second Mortgage Bonds, on its RCF, which is secured by pledged First and Second Mortgage Bonds, and on three series of pollution control bonds, which are secured by pledged Second Mortgage Bonds, from July 1, 1992 through the current date pursuant to applicable orders of the Bankruptcy Court. As discussed below in "Obligations Subject to Compromise," and in Part I, Item 1, "Business - Bankruptcy Proceedings for the Reorganization of the Company - Treatment of Claims Under the Plan," the Company expects to continue such payments. As discussed in more detail in Part I, Item 1, "Business - Bankruptcy Proceedings for Reorganization of the Company - Treatment of Claims Under the Plan," pursuant to requirements under the Plan, at the Confirmation Date, the Company made interest and periodic payments at rates and for periods specified in the Plan on additional classes of creditors and interest holders, together with certain fees and expenses for which payment was provided under the Plan. In addition, pursuant to the Plan, interest payments will be made to such creditors quarterly and on the Effective Date and the Company will make periodic payments to holders of its preferred stock quarterly and on the Effective Date. Through December 31, 1993, such payments or accruals totaled approximately \$40.4 million. The Company estimates the interest and periodic payments will total approximately \$15.4 million per quarter. Taking into account the payments that have been made and the estimated quarterly payments, as well as expected revenues and projected costs for operations and capital expenditures, the Company expects its cash balances will decline; however, the Company does not anticipate any requirement for external financing through the anticipated Effective Date of the Plan.

Obligations Subject to Compromise

In late December 1991, the Company ceased paying principal, interest and fees on portions of its secured and unsecured debt except as described below. The Company also failed to make lease payments of approximately \$19.3 million on Palo Verde Units 2 and 3 due January 2, 1992. All of the Company's debt is in default as a result of the events leading to the bankruptcy filing or the filing itself. The Company expects to remain in default under its existing financing arrangements until a plan of reorganization becomes effective pursuant to the bankruptcy case. These defaults generally would entitle the Company's creditors to accelerate the outstanding principal amounts of debt and pursue other remedies available under the applicable agreements. As a result of the automatic stay imposed by the provisions of the Bankruptcy Code, however, such creditors generally are prevented from taking any action to collect such amounts or pursue any remedies against the Company other than through the bankruptcy case. The terms and provisions of the Company's financing arrangements, including the maturity dates, are subject to modification pursuant to a plan of reorganization confirmed in the bankruptcy case.

First Mortgage Bonds. The Company has approximately \$299.3 million of First Mortgage Bonds outstanding. The Company has not made either final maturity principal payment of approximately

\$10.4 million that was due in 1992 or the approximate \$7 million in cash sinking fund payments due in each of 1992 and 1993 under the Indenture of the First Mortgage Bonds. The Company does not anticipate making the approximate \$7 million cash sinking fund payment due in 1994. Additionally, the Company has not made approximately \$18.2 million in prepetition and postpetition interest payments accrued through June 30, 1992. Pursuant to applicable Bankruptcy Court orders, the Company is making and expects to make monthly interest payments on its First Mortgage Bonds in 1994. Approximately \$30 million of interest accrues annually at the contractual rates on the First Mortgage Bonds outstanding.

Second Mortgage Bonds. The Company has \$165 million of Second Mortgage Bonds outstanding. The Company does not anticipate making the approximate \$8.8 million cash sinking fund payment due in 1994. The Company has not made approximately \$11.7 million in prepetition and postpetition interest payments accrued through June 30, 1992. Pursuant to applicable Bankruptcy Court orders, the Company is making and expects to make monthly interest payments on its Second Mortgage Bonds in 1994. Approximately \$20.3 million of interest accrues annually, based on contract rates, on the Second Mortgage Bonds outstanding.

Pollution Control Bonds. The Company has approximately \$195.6 million of tax exempt Pollution Control Bonds outstanding consisting of four issues, of which three issues aggregating approximately \$159.8 million are secured by a second mortgage. Each of the tax exempt issues is credit enhanced by a letter of credit. Prior to the petition date, interest and other payments on the Pollution Control Bonds were made through draws on the letters of credit and the Company reimbursed the letter of credit bank for such draws. Subsequent to the petition filing, interest on all the bonds has continued to be paid by draws on the letters of credit. The Company has paid a portion of the resulting reimbursement obligations to the issuing banks on three Pollution Control Bond issues through interest payments authorized by applicable orders of the Bankruptcy Court. The Company has not reimbursed the letter of credit banks approximately \$7.3 million in prepetition and postpetition interest payments accrued and paid through draws on the letters of credit through June 30, 1992 on the three series of Pollution Control Bonds. Additionally, the Company has not reimbursed the letter of credit bank for approximately \$4.0 million in prepetition and postpetition interest through December 31, 1993 paid on the fourth pollution control issue through draws on the letter of credit.

In May 1992, one series of the secured Pollution Control Bonds was accelerated and the letter of credit supporting such series was drawn upon for the principal and accrued interest. The Company has not reimbursed the letter of credit bank for the drawing, which aggregated approximately \$37.9 million. The Company has been informed that the letter of credit issuer for the accelerated bonds asserts that the accelerated bonds, which remain outstanding, are held as collateral to secure the reimbursement obligations of the Company to the letter of credit issuer. No court determination has been made as to the validity or enforceability of the collateral interest asserted by such letter of credit issuer. The Company currently is taking steps to amend the governing documents related to this series of Pollution Control Bonds to allow the Bonds to be remarketed during the Company's Bankruptcy Case, at the option of the letter of credit issuer. The amendments also would provide for more flexibility in interest rate features, such as a weekly rate, that would be effective currently, and a letter of credit issuing bank repurchase option that would be effective at the Effective Date of the Plan. The Company expects, but can give no assurance, that the actions necessary to make such amendments will be completed during the second quarter of 1994.

With respect to another series of Pollution Control Bonds, the letter of credit issuer has informed the Company that such letter of credit issuer has purchased all of the outstanding bonds of that series. The Company currently is taking steps to amend the governing documents related to this series of Pollution Control Bonds to allow the Bonds to be remarketed during the Company's Bankruptcy Case, at the option of the letter of credit issuer. The amendments also would provide for more flexibility in interest rate features, such as a weekly rate, that would be effective currently, and a letter of credit

issuing bank repurchase option that would be effective at the Effective Date of the Plan. The Company expects, but can give no assurance, that the actions necessary to make such amendments will be completed during the second quarter of 1994.

A third series of Pollution Control Bonds was remarketed during June 1993 and currently remains outstanding. The final series of Pollution Control Bonds was remarketed in November 1993 and remains outstanding. Both series of Pollution Control Bonds remarketed during 1993 may continue to be remarketed pursuant to the terms of the bonds. The Company currently is taking steps to amend the governing documents of the series of Pollution Control Bonds that have been remarketed annually in June to provide for shorter interest periods currently, which would eliminate the need for annual remarketings, and to institute a repurchase option for the letter of credit bank that would be effective at the Effective Date of the Plan. Such amendments may be made by the redemption of the existing series of Pollution Control Bonds followed by the issuance of a new series of Pollution Control Bonds containing the new provisions, but otherwise equivalent to the existing series. Such actions would require the approvals of the FERC and the New Mexico Commission, and the Company has filed applications seeking such approvals. The Company is attempting to make such changes as of July 1, 1994 in conjunction with the expiration of the current interest period for the existing bonds. The Company expects to make similar changes to the final series of Pollution Control Bonds, which have been remarketed annually in November, at the time of the expiration of the current interest period. The Company may be required to obtain the approval of the FERC and the New Mexico Commission for those changes.

Because of the pendency of the Company's bankruptcy petition as well as other defaults, including the failure of the Company to reimburse the letter of credit issuing banks as described above, the three series of bonds that have not been accelerated are subject to acceleration at any time. In the event that these bonds are accelerated and redeemed, the tax-advantaged interest rate of the bonds may no longer be available to the Company.

RCF. The Company currently has a total of \$150 million of debt outstanding under its RCF. The RCF, which involves a syndicate of money center banks, provided for substantially all of the Company's short-term borrowing prior to the filing of the bankruptcy petition. The RCF became due and payable on January 9, 1992. The RCF is secured by \$50 million of First Mortgage Bonds and \$100 million of Second Mortgage Bonds. Interest on the RCF is calculated at the contract non-default rate, which is the administrating bank's currently quoted prime rate plus 1%. The Company has not paid approximately \$7.9 million of interest accrued through June 30, 1992.

Palo Verde Leases. The Company has not made lease payments aggregating approximately \$201 million on Palo Verde Units 2 and 3 for the period from January 2, 1992 through January 2, 1994. There would be no obligation to make such payments under the Plan. Although the Company has not been paying postpetition obligations arising under the Palo Verde Leases, except as described below, the Company has expensed contract rents for financial reporting purposes of approximately \$20.8 million for each quarter.

Fuel Financings. The Company has (i) a nuclear fuel financing of approximately \$60.6 million secured by nuclear fuel and a note payable of approximately \$9.8 million; and (ii) a fuel oil financing of approximately \$4.9 million secured by fuel oil. The Company has not made payments of any principal on the nuclear fuel financing and note payable since the filing of the bankruptcy petition. The Company also has not made any interest payments on such amounts through September 10, 1993. As a result of the confirmation of the Plan, the Company paid approximately \$1.4 million for interest on the nuclear fuel financing and note payable from September 10, 1993 through December 31, 1993 at the interest rate specified in the Plan, which currently is lower than the contract rate. The total amounts of principal and interest payments that came due but were not paid on the nuclear fuel financing and the note payable totaled \$47.9 million at December 31, 1993. Payments aggregating approximately \$700,000 were made during the second half of 1993 related to the fuel oil financing in

connection with the sale of a portion of the fuel oil inventory. The Company also paid approximately \$150,000 in interest through December 31, 1993 at the interest rate specified in the Plan for unsecured debt in connection with the fuel oil financing.

Unsecured Debt. The Company's unsecured debt consists primarily of: (i) notes payable to banks of approximately \$288.4 million associated with draws on letters of credit related to the Company's sale and leaseback transactions for Palo Verde Units 2 and 3; (ii) a Pollution Control Bond issue of approximately \$35.8 million (on which the Company did not make approximate \$1.2 million interest payments due each of May 1, 1992 and November 2, 1992 and approximate \$700,000 interest payments due on both May 3, 1993 and November 1, 1993, as discussed above); (iii) a term loan note of \$25 million; (iv) a capitalized obligation of approximately \$79.2 million associated with the Palo Verde Unit 2 lease; and (v) a capitalized obligation of approximately \$9.1 million associated with another lease. Prior to the confirmation of the Plan, the Company did not make any payments on the unsecured debt, except for lease payments on the \$9.1 million capitalized obligation. Subsequent to the confirmation of the Plan, the Company has made interest payments on the allowed claims of certain classes of the unsecured creditors, as provided for in the Plan and as discussed in Part I, Item 1, "Business - Bankruptcy Proceedings for the Reorganization of the Company - Treatment of Claims Under the Plan."

Preferred Stock Dividends and Sinking Fund Payments

Under their existing terms, dividends of approximately \$1.86 million on the Company's outstanding cumulative preferred stock are due each January 1, April 1, July 1 and October 1 and mandatory sinking fund redemption payments are due on certain series of the Company's preferred stock on certain of these quarterly dates. On September 19, 1991, the Board of Directors voted to suspend payment of dividends and sinking fund payments on the Company's preferred stock, commencing with dividend and sinking fund payments due October 1, 1991. Accordingly, the Company has defaulted on its obligation to pay all dividends on all such quarterly dates, beginning October 1, 1991, resulting in total unpaid preferred stock dividends of approximately \$18.6 million at December 31, 1993. The Company also has missed sinking fund payments in the following amounts: (i) \$750,000 (7,500 shares at \$100 per share) due each of October 1, 1991, October 1, 1992 and October 1, 1993 on the Company's \$8.95 Dividend Preferred Stock; (ii) \$600,000 (6,000 shares at \$100 per share) due each of October 1, 1991, October 1, 1992 and October 1, 1993 on the Company's \$8.44 Dividend Preferred Stock; (iii) \$400,000 (4,000 shares at \$100 per share) due each of January 1, 1992, January 1, 1993 and January 1, 1994 on the Company's \$10.75 Dividend Preferred Stock; (iv) \$10 million (100,000 shares at \$100 per share) due July 1, 1992 and July 1, 1993 on the Company's \$11.375 Dividend Preferred Stock and (v) \$5 million (50,000 shares at \$100 per share) due July 1, 1992 and July 1, 1993 on the Company's \$10.125 Dividend Preferred Stock. At December 31, 1993 the total arrearage of mandatory sinking fund payments is \$34.9 million. The Company's aggregate mandatory sinking fund redemption payments due during 1994, including the \$400,000 due on January 1, 1994, is approximately \$11.75 million, none of which has been or is anticipated to be paid.

The Company cannot predict when the preferred stock dividends and sinking fund payments will be resumed, but such payments are precluded by the Bankruptcy Code during the Company's Chapter 11 bankruptcy case. Resumption of these payments also will depend on the plan of reorganization ultimately adopted in the Company's bankruptcy case, which could substantially alter or eliminate the rights of the preferred and common stockholders. For a description of the treatment proposed under the Plan, including periodic payments, see Part I, Item 1, "Business-Bankruptcy Proceedings for Reorganization of the Company - Consideration to Shareholders Pursuant to the Plan and Merger," and Part II, Item 5, "Market for Registrant's Common Equity and Related Stockholder Matters."

Operational Challenges

The Company's major franchises are with the Cities of El Paso, Texas, and Las Cruces, New Mexico. The franchises grant the Company the right to utilize public rights-of-way and to place its facilities and structures necessary to serve its retail customers within such cities. The franchise with the City of El Paso expires in March 2001 and does not contain renewal provisions. The Company is facing significant near term challenges in connection with certain of its New Mexico customers, including the City of Las Cruces and the military installations of White Sands Missile Range and Holloman Air Force Base.

City of Las Cruces

The Company's twenty-five year franchise with the City of Las Cruces expired in March 1993. The Company and the City of Las Cruces entered into a one-year franchise while they continued negotiations related to a new long-term franchise. These negotiations have not resulted in a new franchise and the one-year franchise expired March 18, 1994. The Company has continued to provide electric service to customers in the City of Las Cruces, consistent with its view that the right and obligation to serve customers within the City of Las Cruces is derived from the New Mexico Public Utility Act, as well as other New Mexico law, and not from the franchise. The City of Las Cruces has acknowledged this obligation in a press release issued March 12, 1994. Sales to customers in the City of Las Cruces represented approximately 7% of the Company's operating revenue in 1993.

The City of Las Cruces is continuing its exploration and consideration of alternatives for electric service that may be available to it, including construction of its own distribution system and/or purchase or condemnation of all or a portion of the Company's distribution system and other property in the Las Cruces metropolitan area. In March 1993, the City of Las Cruces presented a proposal, which the Company rejected, to purchase the Company's facilities used to serve customers within the City of Las Cruces. Nevertheless, in January 1994, the City of Las Cruces issued two requests for proposals ("RFPs"), one with respect to the provision of a long-term supply of wholesale electric power and one with respect to operations and maintenance services for a distribution system in the City of Las Cruces. Proposals in response to the RFPs were due no later than February 28, 1994. The City of Las Cruces has not announced any decisions related to the RFPs or its intentions with respect to the development of a competitive distribution system in view of the Company's refusal to sell its distribution system. The Company did not respond to the RFPs, consistent with its position that the franchise agreement does not govern the right or obligation to provide electric service.

The Company and the City of Las Cruces are continuing discussions related to the provision of electric service to customers within the City of Las Cruces. The Company also is considering the level of franchise fees that should be paid if the franchise agreement is not replaced. The Company believes that it will continue to provide electric service to the City of Las Cruces for the immediate future, either under a franchise agreement or without an agreement in place, but pursuant to its right and obligation under New Mexico law. If the City of Las Cruces and the Company do not agree to a new franchise agreement and the City of Las Cruces attempts to change the provider of electric service, the Company will challenge such actions in the New Mexico Commission, the appropriate courts, or both.

Military Installations

The Company is a party to contracts with each of the United States Department of the Air Force ("Air Force") and the United States Department of the Army ("Army") regarding the provision of retail electric service at Holloman Air Force Base and White Sands Missile Range, respectively, located in New Mexico. The Company's sales pursuant to such contracts represented approximately 2% of revenues in 1993. The Company's right to provide this service was authorized by the New Mexico Commission in 1956 by the issuance of a CCN to the Company. The contract with the Army was due to expire on December 31, 1993 but has been extended by unilateral action of the Army for an

indefinite period. The contract with the Air Force expired on February 28, 1994. The Company continues to provide the electric service under state approved tariffs and CCN authority. In 1993 the Army notified the Company that it intends to conduct a competitive bidding procedure to determine the provider of this electric service after expiration of the contract, but has taken no further action. On June 15, 1993, the Air Force issued an RFP to prospective electric utility service providers to provide electric service to Holloman Air Force Base upon expiration of its service agreement with the Company. Responses to the RFP were due August 12, 1993. The Company submitted its proposal to the Air Force on August 12, 1993 and filed a protest to the issuance and terms of the Air Force's RFP. The protest was upheld, but on technical grounds that have allowed the Air Force to proceed with the competitive bidding process, although it was delayed.

The Company believes that the procurement of retail electric service by the United States Department of Defense by such competitive procedures is prohibited by applicable federal procurement law and that participation by public utilities in such competitive procedures to attempt to obtain the right to provide this retail electric service would be contrary to New Mexico utility regulatory law and a violation of the Company's state-authorized right to provide this service. On April 1, 1993, the Company filed a Petition for Declaratory Order with the New Mexico Commission seeking, among other things, a declaration that the Company currently is the only public utility authorized under New Mexico utility regulatory law to offer and provide this particular retail electric service to Holloman Air Force Base and White Sands Missile Range. This proceeding has been docketed as NMPUC Case No. 2505. The hearing examiner appointed to the case issued a report recommending that the New Mexico Commission determine that the case is not ripe for determination. In September, the Attorney General of New Mexico filed exceptions to the hearing examiner's recommended decision. The Attorney General has taken the position that the case is ripe for decision and has urged the New Mexico Commission to declare that utilities may not compete or contract to provide retail service to existing loads of another utility in a bidding process conducted outside of a proceeding before the New Mexico Commission. The New Mexico Commission has not yet issued its decision. Although the Company believes that it is more probable than not that it will continue to have the right and obligation to provide the retail electric service to the two military installations, there is no assurance that this will be the case.

On January 4, 1994, the Company filed an action against the Air Force and related parties in the United States District Court for the District of New Mexico seeking declaratory and injunctive relief, No. CIV 94-6. The action requests a preliminary injunction against the Air Force's competitive bid process for electric service at Holloman Air Force Base until the court determines whether the competitive bid process is contrary to federal law. The action also requests (i) a permanent injunction of competitive procurement of the retail electric utility service for Holloman Air Force Base from any public utility regulated under the New Mexico Public Utility Act, and (ii) a declaratory judgment that the competitive procurement of the retail electric utility service for Holloman Air Force Base currently provided by the Company from any public utility regulated under the New Mexico Public Utility Act using competitive procedures based on "lowest net cost of service" is prohibited by federal law because it is inconsistent with New Mexico law governing the provision of the service by public utilities. A hearing on the Company's request for a preliminary injunction has been scheduled before the United States District Court for April 18, 1994.

The Company believes that it will continue to provide electric service to the City of Las Cruces, Holloman Air Force Base and White Sands Missile Range for the immediate future. The Company also intends to pursue all available means, including litigation, to retain such customers for the long term and believes, but can give no assurance, that it will prevail in its efforts to retain such customers in the long term. If the Company is unable to do so, however, the Company intends to pursue all available regulatory and legal avenues to obtain the appropriate recovery of its stranded investment related to such customers.

Other

On February 8, 1993, Southern Union Gas Company ("Southern Union") filed a request with the City of El Paso that Southern Union's present franchise to provide gas service be amended to permit Southern Union to provide electric service. Such proposed service would compete with service provided by the Company. The City of El Paso has not acted on Southern Union's request. Southern Union has not applied to the Texas Commission for a service territory CCN or a CCN to construct facilities, although such CCNs would be required in addition to the requested amendment to Southern Union's franchise. Currently, the Company holds the only franchise with the City of El Paso to provide electric service inside the City, as well as the only CCN from the Texas Commission authorizing electric service inside the City. The Company will oppose any request by Southern Union for a CCN to provide electric service inside the City of El Paso, but the Company cannot predict whether a CCN would be granted to Southern Union if one is requested from the Texas Commission or whether the City of El Paso will amend Southern Union's franchise.

General Industry

In addition to these specific challenges, the Company faces many of the challenges facing the electric utility industry as a whole, including competitive factors and the costs of nuclear investment and decommissioning. The level of competition has increased as a result of changes in federal regulatory provisions related to transmission practices and independent power production, including cogeneration projects. The Energy Policy Act includes provisions authorizing the FERC to order electric utilities to transmit power at wholesale at the request of third parties, such as independent power producers and other utilities. Implementation of these provisions may involve changes in the method of transmission pricing and increased compliance reporting to the FERC regarding transmission system availability. State legislatures such as the New Mexico legislature also have indicated they are considering retail wheeling policies that could result in increases to competition. The Company believes one benefit to the proposed Merger would be an improved ability to meet these industry challenges.

Decommissioning costs continue to be significant to the Company. The costs are based on studies that are updated periodically (generally every three years). The most recent study, dated December 1993, estimates the cost to decommission the Company's share of Palo Verde to be approximately \$221 million (stated in 1993 dollars). As of December 31, 1993, the Company has accrued approximately \$30.1 million for decommissioning costs and the balance of funds in decommissioning trusts established by the Company totaled approximately \$15.8 million. The updated studies have continually reflected increases in costs to decommission as new developments unfold surrounding the technical and safety aspects of decommissioning a nuclear facility. Although the Company is funding and recording costs based on the latest information available, there can be no assurances that decommissioning costs will not continue to increase in the future. Due to delays in the construction of nuclear waste storage facilities as a result of opposition at the state and local level to the siting of facilities, the Company may incur additional costs for the construction and operation of temporary or permanent storage facilities at Palo Verde. See "Financial Statements and Supplementary Data - Note E of Notes to Financial Statements."

The Energy Policy Act also provided for an assessment for the decontamination and decommissioning of DOE's uranium enrichment facilities. The Company has been advised by APS that, based on preliminary indications, the annual assessment for Palo Verde is expected to be approximately \$3 million for fifteen years, plus increases for inflation. The Company will pay 15.8% of the annual Palo Verde assessment. The Company accrued \$7.1 million for this assessment in 1992 as its portion of the entire assessment, and paid \$400,000 to APS in 1993.

Results of Operations

The Company recorded a net loss applicable to common stock of \$137.9 million or \$3.88 per share in 1993. This compares to a net loss of \$28.2 million (\$.79 per share) and \$564.3 million (\$15.89 per share) in 1992 and 1991, respectively. The principal factors giving rise to the loss in 1993 are (i) revenues that are not sufficient to recover fully the Company's costs of service and debt service, (ii) reorganization expenses incurred in connection with the Bankruptcy Case, and (iii) recognition of the effects of a change in accounting principle for income taxes. Similarly, the 1992 loss resulted from insufficient revenues and reorganization expenses, including the write-off of debt issuance costs. Operating results for 1991 are not readily comparable to 1993 and 1992 since prior to December 31, 1991 the Company reported its operating results in accordance with SFAS No. 71. See "Financial Statements and Supplementary Data - Notes C and D of Notes to Financial Statements." The Company does not anticipate any significant changes in results of operations prior to emergence from bankruptcy. See Part I, Item 1, "Business - Bankruptcy Proceedings for Reorganization of the Company - Regulatory Aspects of the Plan."

The primary reasons for increases or decreases in revenues, expenses and other items affecting results of operations for the year ended December 31, 1993 compared to the year ended December 31, 1992; and for the year ended December 31, 1992 compared to the year ended December 31, 1991 are discussed below.

Operating Revenues

Approximately 59% of the Company's total revenues for the year ended December 31, 1993 were generated from sales of electricity to Texas retail customers, principally in the City of El Paso, at rates approved by the Texas Commission. Sales of electricity to New Mexico retail customers, the largest portion of which are in the City of Las Cruces and certain military installations, represent 16% of the Company's total revenues for such period. The balance of the Company's revenues are generated through: (i) negotiated long-term contracts which are approved by the FERC (16% of the Company's revenues for such period); and (ii) sales to CFE and economy energy sales which are based upon current market prices (collectively, 9% of the Company's revenues for such period). 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%, 35%, 12% and 18%, respectively, of the Company's operating revenue from retail sales. In 1993, IID, a wholesale customer, accounted for 10.1% of operating revenues. No retail customer accounted for more than 3% of operating revenues. See "Financial Statements and Supplementary Data - Note M of Notes to Financial Statements."

Revenues by quarter typically vary due to the difference in climate throughout the year in the Company's service area, reflecting higher temperatures and rate tariffs in the summer months. Traditionally, operating revenues during the third quarter (the highest sales quarter) tend to be 20-25% greater than operating revenues generated during the first quarter (the lowest sales quarter).

Operating revenues in 1993 were 3.6% greater than operating revenues reported in 1992, while operating revenues in 1992 were 13.5% greater than in 1991. The changes in operating revenues were attributable to the following (In thousands):

	<u>1993 versus 1992</u>	<u>1992 versus 1991</u>
Base revenues	\$ 16,064	\$ 60,427
Fuel revenues	15,457	2,233
Other	<u>(12,687)</u>	<u>(305)</u>
	<u>\$ 18,834</u>	<u>\$ 62,355</u>

Base Revenues. The base revenue increase in 1993 is principally the result of (i) increases in total system KWH sales of approximately 2.9% and (ii) increases in demand and capacity charges to CFE and increases in capacity for IID. Increases in base revenues for 1992 were largely due to: (i) cash rate increases of approximately \$30 million and \$7 million annually, effective August 1991 and September 1991, respectively, which were granted by the Texas Commission in Docket No. 9945; (ii) increases in total system KWH sales of approximately 13.0%; and (iii) increases in demand charges to IID for increased capacity.

Changes in KWH sales for 1993 compared to 1992 and 1992 compared to 1991 by customer class are as follows:

	<u>1993 versus 1992</u>	<u>1992 versus 1991</u>
Native system:		
Residential	2.1%	3.9%
Commercial and industrial - small	3.9	2.9
Commercial and industrial - large	(4.3)	5.5
Public authorities	3.7	4.3
Native system composite	1.8	3.9
Sales for resale	5.2	37.5
Total system composite	2.9	13.0

Total system firm energy sales increased from 7,220,871 MWH in 1992 to 7,432,205 MWH for 1993. Native system firm sales increased 88,410 MWH over the same time period. The number of customers from December 31, 1992 to December 31, 1993 increased by approximately 2.8%. The Company achieved record peak demands in 1993, recording an all-time total system peak load of 1,335 MW on August 11, 1993, which was a 2.5% increase over 1992's record peak of 1,302 MW. The Company's 1993 native system peak demand of 997 MW, which was also a new record, was a 2.4% increase from the previous record of 974 MW set in 1992.

As indicated in the table above, and except for the decline in large commercial and industrial customers in 1993 as compared to 1992, the growth in native system sales is consistent with increases in the number of customers served. The reduction of KWH sales in 1993 as compared to 1992 to large commercial and industrial customers results from (i) the temporary cessation and temporary reduction in operations by two customers and (ii) a reduction in sales to a third customer.

Fuel Revenues. Changes in fuel revenues are generally a function of changes in fuel and purchased and interchanged power expenses. However, because the Company has recorded a provision for the sharing of profit from sales to certain customers and economy energy sales, the increase in fuel costs will not be offset entirely by increases in fuel revenues.

Other. The 1993 reduction in other revenues is principally due to the discontinuance of surcharges (related to the recovery of regulatory expenses) recorded in 1992 of approximately \$11.7 million. In addition, economy energy sales decreased approximately \$1.9 million.

Fuel and Purchased and Interchanged Power Expenses

The increase in fuel and purchased and interchanged power expense in 1993 compared to 1992 was due primarily to increased purchased power cost as a result of decreased power production at Palo Verde and at local gas facilities, and increased unit gas costs.

The increase in fuel and purchased and interchanged power expense in 1992 compared to 1991 was due primarily to increased production at local gas facilities and increased unit gas costs, offset by decreased unit nuclear fuel costs.

Operation and Maintenance Expense

Operation and maintenance expense increased in 1993 as a result of (i) increased pension and benefit costs, including an additional expense of \$6.3 million in connection with the adoption of SFAS No. 106 on January 1, 1993 and the recording of approximately \$4 million for retirement agreements with five former officers who retired in early 1994; and (ii) the settlement of certain transmission disputes of approximately \$2.4 million in 1993. These increases were offset in part by (i) decreased outside services resulting from decreased legal costs of approximately \$5 million; (ii) decreased Palo Verde costs of approximately \$3.6 million; and (iii) a decrease in bad debt expense of approximately \$2 million.

Operation and maintenance expense increased in 1992 due to increased non-Palo Verde costs resulting from (i) an additional provision of approximately \$3.1 million for uncollectible accounts associated with three large customers; (ii) the accrual of approximately \$1.8 million in connection with estimated environmental remediation costs; and (iii) increased local plant maintenance costs. The above increase was partially offset by decreased Palo Verde costs resulting from recording costs associated with an early retirement plan in 1991 with no comparable amount in 1992.

Depreciation and Amortization Expense

Depreciation expense decreased in 1993 compared to 1992 due primarily to a \$7.1 million DOE decommissioning charge reported in 1992 in connection with the Energy Policy Act, with no comparable adjustment in 1993. The decrease was partially offset by an increase in the Company's share of decommissioning expense related to Palo Verde, based on an updated study. For a discussion of decommissioning costs, see "Operational Challenges - General Industry" above and "Financial Statements and Supplementary Data—Note E of Notes to Financial Statements."

Depreciation expense increased in 1992 compared to 1991 due primarily to the \$7.1 million DOE assessment on Palo Verde and depreciation taken on the Texas portion of Palo Verde Unit 3.

Amortization expense decreased in 1992 compared to 1991 as a result of the discontinuance of the application of SFAS No. 71.

Federal Income Taxes

The Company recorded federal income tax benefits of approximately \$7.9 million in 1993. The increase in tax benefits in 1993 compared to tax benefits of approximately \$4 million recognized in 1992 results from (i) differences in recognizing income taxes under the provisions of SFAS No. 109 in 1993 as compared to APB Opinion No. 11 in 1992, primarily the recognition of the one percent increase

in the federal income tax rate; (ii) an increase in pre-tax loss, net of non-deductible reorganization costs; and (iii) other adjustments to deferred taxes.

The Company recorded federal income tax benefits of approximately \$107 million in 1991. The decrease in income tax benefits in 1992 as compared to 1991 is primarily the result of a decrease in the pre-tax loss, net of non-deductible reorganization costs incurred in 1992.

Taxes Other Than Federal Income Taxes

Taxes other than federal income taxes increased in 1993 compared to 1992 due primarily to the accrual of approximately \$6.2 million for the settlement and anticipated settlement of state income and other tax claims.

Investment Income

Investment income decreased in 1992 compared to 1991 due to interest received in 1991 of approximately \$2.4 million on an income tax refund and interest of approximately \$1 million related to a note receivable with no comparable amounts received in 1992. Beginning January 8, 1992, interest earned on accumulated cash balances due to reorganization is reported under the heading "Reorganization Items" in the Statements of Operations.

Other Income, Net

Other income, net increased in 1993 compared to 1992 due to a gain of approximately \$3 million recognized in the second quarter of 1993 for the settlement of civil litigation.

Interest Charges

Interest charges increased in 1993 compared to 1992 primarily due to payments of approximately \$10.2 million upon confirmation of the Plan to unsecured and undersecured creditors, which interest had not been previously accrued, and a \$1.6 million charge in 1993 in connection with the settlement and anticipated settlement of state income and other tax claims as discussed above. The increase was partially offset by a reduction in interest rates.

Interest charges decreased in 1992 compared to 1991 due to the discontinuation of accruing interest on the Company's unsecured and undersecured debt, and a decrease in the secured long-term and short-term debt rates. The decrease is partially offset by interest on increased outstanding balances under the RCF.

Reorganization Items

Pursuant to the provision of Statement of Position 90-7, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code" ("SOP 90-7"), the Company reports net expenses incurred as a result of the bankruptcy proceedings in a separate section in the statements of operations. Professional fees and other costs increased in 1993 as a result of additional payments pursuant to the Plan following the Confirmation Date. In addition, in accordance with SOP 90-7, the Company incurred a one-time write-off in 1992 of debt issuance cost of approximately \$13.3 million.

Cumulative Effect of a Change in Accounting Principle

Effective January 1, 1993, the Company began reporting its financial results pursuant to the provisions of SFAS No. 109. The standard requires the use of the asset and liability method of accounting for income taxes as opposed to the deferred method. The Company recognized a charge to operations in January 1993 of approximately \$96 million as a result of adopting SFAS No. 109. The

charge to operations consists of federal income tax benefits of approximately \$153.2 million and state income tax benefits of approximately \$12.2 million, less valuation allowances of approximately \$219.2 million and \$42.2 million, respectively.

Preferred Stock Dividend Requirements

The Company has discontinued accruing dividends on preferred stock due to the Company's bankruptcy filing. See "Financial Statements and Supplementary Data—Note G of Notes to Financial Statements."

Other 1991 Items

During 1991, the Company recorded an extraordinary item for the discontinuance of the application of SFAS No. 71, a loss on the letter of credit draws, and an expense for debt restructuring, all of which did not recur in 1992 and 1993. In addition, after discontinuance of application of SFAS No. 71 in 1991, the Company no longer records the effects of regulation, and accordingly, certain items recorded in 1991 are not reflected in 1992 and 1993.

Effects of Inflation

Over the recent past, inflation has been relatively low. As such, its impact to the Company's results of operations and financial condition have not been significant.

Environmental Matters

For a discussion of environmental matters, see Part I, Item 1, "Business—Environmental Matters."

Effect of Recently Issued Accounting Standards

See "Financial Statements and Supplementary Data – Note D of Notes to Financial Statements" regarding the effect of SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities."

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Item 8. Financial Statements and Supplementary Data

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INDEPENDENT AUDITORS' REPORT

The Shareholders and Board of Directors
El Paso Electric Company:

We have audited the financial statements of El Paso Electric Company (a debtor-in-possession as of January 8, 1992) as listed in the accompanying index. 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, 1993 and 1992, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 1993 in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that El Paso Electric Company will continue as a going concern. As discussed in Note A of Notes to Financial Statements, El Paso Electric Company filed a voluntary petition for reorganization under Chapter 11 of the United States Bankruptcy Code on January 8, 1992. The Chapter 11 case is administered by the United States Bankruptcy Court for the Western District of Texas. The Company is operating its business as debtor-in-possession which requires certain of its actions to be approved by the Bankruptcy Court. The Bankruptcy Court has confirmed the Company's proposed plan of reorganization which contemplates the Company would be acquired by Central and South West Corporation. Consummation of the plan of reorganization is subject to the satisfaction of certain significant conditions, including numerous regulatory approvals. Continuation of the Company as a going concern is dependent upon, among other things, the consummation of a plan of reorganization, the Company's ability to generate sufficient cash from operations, most significantly its operations which are subject to regulation of the rates it is allowed to charge as described in Note C of Notes to Financial Statements, and its ability to restructure or obtain financing to meet its obligations. Further, as more fully described in Notes B, H, J, and K of Notes to Financial Statements, significant claims beyond those reflected as liabilities in the financial statements at December 31, 1993 have been or may be asserted against the Company. The validity of these claims, as well as the amount and manner of payment of all valid claims, will ultimately be determined by the Bankruptcy Court. These matters raise substantial doubt about the Company's ability to continue as a going concern. As a result of the reorganization proceedings, the Company may sell or otherwise realize assets and liquidate or settle liabilities for amounts other than those reflected in the financial statements. Further, the consummation of a plan of reorganization could materially change the amounts currently recorded in the financial statements, and if no reorganization plan is consummated, it is possible that the Company's assets could be liquidated. The financial statements do not include any adjustments that might result from the outcome of these uncertainties.

As discussed in Notes I and L, the Company changed its methods of accounting for income taxes and postretirement benefits other than pensions, effective January 1, 1993.

KPMG PEAT MARWICK

El Paso, Texas
March 30, 1994

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

BALANCE SHEETS

ASSETS

	December 31,	
	1993	1992
(In thousands)		
Utility plant (Notes C, D and E):		
Electric plant in service	\$ 1,650,899	\$ 1,620,796
Less accumulated depreciation and amortization	<u>381,309</u>	<u>342,527</u>
Net plant in service	1,269,590	1,278,269
Construction work in progress	51,267	41,946
Nuclear fuel; includes fuel in process of \$9,937,000 and \$16,192,000, respectively	93,909	105,654
Less accumulated amortization	<u>41,948</u>	<u>44,559</u>
Net nuclear fuel	51,961	61,095
Net utility plant	<u>1,372,818</u>	<u>1,381,310</u>
Current assets:		
Cash and temporary investments	181,086	162,535
Accounts receivable, principally trade, net of allowance for doubtful accounts of \$6,004,000 and \$4,769,000, respectively	54,652	51,896
Inventories	34,595	36,578
Prepayments and other	<u>10,035</u>	<u>11,351</u>
Total current assets	280,368	262,360
Long-term contract receivable (Note C)	32,420	30,049
Deferred charges and other assets	29,800	29,059
Total assets	\$ 1,715,406	\$ 1,702,778

See accompanying notes to financial statements.

EL PASO ELECTRIC COMPANY
(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

BALANCE SHEETS
CAPITALIZATION AND LIABILITIES

	<u>December 31,</u>	
	<u>1993</u>	<u>1992</u>
Capitalization (Notes A, F, G and H):		(In thousands)
Common stock, no par value, 100,000,000 shares authorized.		
Issued and outstanding 35,544,330 and 35,534,963 shares, respectively (Note F)	\$ 339,097	\$ 339,078
Accumulated deficit	(696,560)	(558,661)
Allowance for pension liability, less applicable income tax benefits of \$476,000 in 1992	-	(925)
Common stock deficit	(357,463)	(220,508)
Preferred stock, cumulative, no par value, 2,000,000 shares authorized:		
Redemption required	67,266	67,266
Redemption not required	14,198	14,198
Obligations subject to compromise (Note H)	<u>1,495,315</u>	<u>1,440,968</u>
Total capitalization	<u>1,219,316</u>	<u>1,301,924</u>
Current liabilities:		
Accounts payable, principally trade	37,032	26,120
Customer deposits	4,905	4,719
Taxes accrued other than federal income taxes	21,658	20,374
Net overcollection of fuel revenues	13,874	13,635
Other	9,408	14,030
Total current liabilities	<u>86,877</u>	<u>78,878</u>
Deferred credits and other liabilities:		
Accumulated deferred income taxes (Note I)	123,935	46,028
Accumulated deferred investment tax credit (Note I)	68,992	74,455
Deferred gain on sales and leasebacks (Note B)	142,543	149,575
Decommissioning (Note E)	30,101	22,001
Other	43,642	29,917
Total deferred credits and other liabilities	<u>409,213</u>	<u>321,976</u>
Commitments and contingencies (Notes A, B, C, J, K and L)		
Total capitalization and liabilities	<u>\$ 1,715,406</u>	<u>\$ 1,702,778</u>

See accompanying notes to financial statements.

EL PASO ELECTRIC COMPANY
(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

STATEMENTS OF OPERATIONS

For the years ended December 31, 1993, 1992 and 1991
 (In thousands except per share data)

	1993	1992	1991
Operating revenues	\$ 543,594	\$ 524,760	\$ 462,405
Operating expenses:			
Operation:			
Fuel	93,007	90,840	82,418
Purchased and interchanged power	<u>38,997</u>	<u>16,858</u>	<u>18,326</u>
Other	133,004	107,698	100,744
Maintenance	206,576	204,334	203,239
Depreciation and amortization	39,450	39,351	31,467
Palo Verde deferred costs (Note C)	53,050	56,869	57,926
Phase-in plan deferrals (Note C)	—	—	(18,296)
Taxes:			
Federal income tax benefits (Note I)	(10,360)	(1,067)	(10,844)
Other	<u>56,903</u>	<u>50,539</u>	<u>49,038</u>
	<u>478,623</u>	<u>457,724</u>	<u>411,683</u>
Operating income	<u>64,971</u>	<u>67,036</u>	<u>50,722</u>
Other income (deductions):			
Allowance for equity funds used during construction (Note D)	—	—	68
Phase-in plan deferred return (Note C)	—	—	1,719
Regulatory disallowance (Note C)	—	—	(30,978)
Restructuring costs	—	—	(10,773)
Investment income	—	—	5,529
Loss attributable to letters of credit draws (Note B)	—	—	(268,416)
Other, net	2,838	754	696
	<u>(831)</u>	<u>(343)</u>	<u>73,835</u>
Federal income (taxes) benefits applicable to other income (Note I)	<u>2,007</u>	<u>411</u>	<u>(248,320)</u>
	<u>66,978</u>	<u>67,447</u>	<u>(197,598)</u>
Income (loss) before interest charges	<u>66,978</u>	<u>67,447</u>	<u>(197,598)</u>
Interest charges (credits):			
Interest	82,237	73,176	92,876
Palo Verde deferred costs - carrying charges (Note C)	—	—	(13,393)
Other interest capitalized and deferred	<u>(3,998)</u>	<u>(3,817)</u>	<u>(6,393)</u>
Allowance for borrowed funds used during construction (Note D)	—	—	(3,776)
	<u>78,239</u>	<u>69,259</u>	<u>69,314</u>
Loss before reorganization and extraordinary items and cumulative effect of a change in accounting principle	<u>(11,261)</u>	<u>(1,812)</u>	<u>(266,912)</u>
Reorganization items (expense):			
Debt costs	—	(19,264)	—
Professional fees and other	<u>(35,150)</u>	<u>(20,194)</u>	—
Interest earned on accumulated cash resulting from Bankruptcy case	6,152	3,806	—
Federal income (taxes) benefits applicable to reorganization items	<u>(1,596)</u>	<u>3,284</u>	—
	<u>(30,594)</u>	<u>(26,368)</u>	—
Loss before extraordinary item and cumulative effect of a change in accounting principle	<u>(41,855)</u>	<u>(28,180)</u>	<u>(266,912)</u>
Extraordinary item, less applicable income tax benefits of \$22,385 (Notes C and I)	<u>—</u>	<u>—</u>	<u>(289,102)</u>
Loss before cumulative effect of a change in accounting principle	<u>(41,855)</u>	<u>(28,180)</u>	<u>(556,014)</u>
Cumulative effect of a change in accounting principle (Note I)	<u>(96,044)</u>	<u>—</u>	<u>—</u>
Net loss	<u>(137,899)</u>	<u>(28,180)</u>	<u>(556,014)</u>
Preferred stock dividend requirements (\$3,725 unpald) (Note G)	<u>—</u>	<u>—</u>	<u>8,274</u>
Net loss applicable to common stock	<u>\$ (137,899)</u>	<u>\$ (28,180)</u>	<u>\$ (564,288)</u>
Net loss per weighted average share of common stock:			
Loss before extraordinary item and cumulative effect of a change in accounting principle	<u>\$ (1.18)</u>	<u>\$ (0.79)</u>	<u>\$ (7.75)</u>
Extraordinary item	<u>(2.70)</u>	<u>—</u>	<u>(8.14)</u>
Cumulative effect of a change in accounting principle	<u>—</u>	<u>—</u>	<u>—</u>
Net loss	<u>\$ (3.88)</u>	<u>\$ (0.79)</u>	<u>\$ (16.89)</u>

See accompanying notes to financial statements.

EL PASO ELECTRIC COMPANY
(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

STATEMENTS OF ACCUMULATED DEFICIT

For the years ended December 31, 1993, 1992 and 1991
(In thousands)

	<u>1993</u>	<u>1992</u>	<u>1991</u>
Retained earnings (deficit) at beginning of year	\$ (558,661)	\$ (530,481)	\$ 33,388
Add:			
Net loss	<u>(137,899)</u>	<u>(28,180)</u>	<u>(556,014)</u>
	<u><u>(696,560)</u></u>	<u><u>(558,661)</u></u>	<u><u>(522,626)</u></u>
Deduct:			
Cash dividends (Notes F and G):			
Preferred stock	—	—	4,549
Cumulative dividends in arrears:			
Preferred stock-redemption required (Note G)	—	—	3,306
	<u>—</u>	<u>—</u>	<u>7,855</u>
Accumulated deficit at end of year	<u>\$ (696,560)</u>	<u>\$ (558,661)</u>	<u>\$ (530,481)</u>
Weighted average number of common shares outstanding	<u>35,539,480</u>	<u>35,530,264</u>	<u>35,515,060</u>

See accompanying notes to financial statements.

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

STATEMENTS OF CASH FLOWS
For the years ended December 31, 1993, 1992 and 1991

	<u>1993</u>	<u>1992</u>	<u>1991</u>
	(In thousands)		
Cash Flows From Operating Activities:			
Loss before extraordinary item and cumulative effect of a change in accounting principle	\$ (41,855)	\$ (28,180)	\$ (266,912)
Adjustments for non-cash items from operating activities:			
Depreciation and amortization	66,901	69,219	78,068
Deferred income taxes and investment tax credit, net	(24,077)	(4,008)	(84,679)
Allowance for equity funds used during construction	-	-	(68)
Loss attributable to letters of credit draws	-	-	288,416
Regulatory disallowance	-	-	30,978
Debt costs	-	13,264	-
Other operating activities	(1,787)	(1,784)	3,171
Change in:			
Accounts receivable	(2,756)	(1,582)	(6,097)
Inventories	1,983	6,090	(7,501)
Prepayments and other	1,316	5,815	13,247
Long-term contract receivable	(2,371)	(2,850)	(4,909)
Obligations subject to compromise	55,214	101,486	-
Accounts payable	10,912	26,119	2,916
Other current liabilities	(2,913)	28,753	3,453
Deferred charges and credits	16,637	5,530	(44,963)
Net cash provided by operating activities	77,204	217,872	5,120
Cash Flows From Investing Activities:			
Additions to utility plant	(58,215)	(60,570)	(63,462)
Allowance for equity funds used during construction	-	-	68
Other investing activities	409	-	1,295
Net cash used for investing activities	(57,806)	(60,570)	(62,099)
Cash Flows From Financing Activities:			
Proceeds from long-term obligations	-	-	43,133
Redemption of securities	-	-	(15,400)
Dividends paid	-	-	(4,549)
Redemption of long-term obligations	(867)	(788)	(118,081)
Net increase in short-term obligations	-	-	145,000
Other financing activities	20	30	745
Net cash provided by (used for) financing activities	(847)	(758)	50,848
Net increase (decrease) in cash and temporary investments	18,551	156,544	(6,131)
Cash and temporary investments at beginning of year	162,535	<b">5,991</b">	12,122
Cash and temporary investments at end of year	\$ 181,086	<b">\$ 162,535</b">	<b">\$ 5,991</b">
Supplemental Disclosures of Cash Flow Information:			
Cash paid during the year for:			
Income taxes	\$ 17,064	\$ -	\$ -
Interest	64,712	32,498	82,438
Reorganization items:			
Cash interest received on accumulated cash resulting from Bankruptcy case	5,685	3,361	-
Cash paid for professional fees and other	29,021	11,759	-

See accompanying notes to financial statements.

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS

A. Bankruptcy and Going Concern Presentation

On January 8, 1992 ("Petition Date") El Paso Electric Company (the "Company") filed a petition for reorganization under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Western District of Texas, Austin Division (the "Bankruptcy Court"). The filing followed an attempt by the Company during 1991 to negotiate a restructuring of its obligations with its creditors and the draws in late December 1991 on letters of credit related to the Company's sale and leasebacks of portions of its interest in Palo Verde. Since the Petition Date, the Company has operated its business as debtor-in-possession, subject to the approval of the Bankruptcy Court for certain of its proposed actions. On December 8, 1993 (the "Confirmation Date"), the Bankruptcy Court entered an order confirming the Company's Modified Third Amended Plan of Reorganization, as corrected through December 6, 1993 (the "Plan"). The effectiveness of the Plan is subject to satisfying certain significant conditions, discussed below.

As of January 8, 1992, actions to collect prepetition indebtedness or pursue prepetition claims were stayed and contractual obligations incurred prepetition may not be enforced against the Company. The Company has rejected certain executory contracts and leases as permitted by the United States Bankruptcy Code, 11 U.S.C. §101 et seq. ("Bankruptcy Code") and claims arising from such rejections have been or will be addressed through the reorganization process. Substantially all liabilities as of the Petition Date would be modified pursuant to the Plan, which was approved by all classes of impaired creditors and equity security holders in the voting process and confirmed by the Bankruptcy Court on December 8, 1993. (See Note H for a description of estimated liabilities subject to compromise).

The discussions and descriptions of Company events and the analysis of their potential impact on financial results herein are premised on the assumption that the Company's operations will be maintained within existing financial agreements, as modified by the Plan, and regulatory structures prior to the effective date of the Plan ("Effective Date"). This report must be read with the understanding that the Plan, which has been confirmed by the Bankruptcy Court, but has not become effective, will alter, compromise or modify the existing financial and regulatory structures if it becomes effective. Substantial conditions to the Plan becoming effective exist, as discussed herein, and the Company believes, but can give no assurance, that such conditions will be satisfied. It is possible that the Plan will not become effective. If the Plan does not become effective, another plan of reorganization also would alter, compromise or modify existing financial and regulatory structures. See "Alternatives to the Plan," below. It is therefore not possible at this time to state with certainty the nature or degree to which the existing financial and regulatory structures will be altered, compromised or modified. Accordingly, estimates and evaluations based on the historical results of Company operations could be subject to material changes as a result of the eventual resolution of the case commenced January 8, 1992 by the Company in the Bankruptcy Court as Case No. 92-10148-FM ("Bankruptcy Case").

The financial statements have been prepared assuming that the Company will continue as a going concern. Continuation of the Company as a going concern is dependent upon, among other things, a plan of reorganization becoming effective, the Company's ability to generate sufficient cash from operations, most significantly its operations which are subject to regulation of the rates it is allowed to charge as described in Note C, and its ability to restructure or obtain refinancing to meet its obligations. Further, as more fully described in Notes B, H, J and K, significant claims beyond those reflected as liabilities in the financial statements at December 31, 1993 have been asserted against the Company. The validity of these claims, as well as the amount and manner of payment of all valid claims, will ultimately be determined by the Bankruptcy Court. As a result of the reorganization proceedings, the Company may sell or otherwise realize assets and liquidate or settle liabilities for

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

amounts other than those reflected in the financial statements. Further, the effectiveness of a plan of reorganization, could materially change the amounts currently recorded in the financial statements and if no reorganization plan becomes effective, it is possible that the Company's assets could be liquidated. The financial statements do not include any adjustments that might result from the outcome of these uncertainties.

The Plan and Proposed Merger

Background. On May 5, 1993, the Company filed the Plan and the Disclosure Statement to the Third Amended Plan of Reorganization ("the Disclosure Statement"), which provide for the reorganization of the Company and its acquisition by Central and South West Corporation ("CSW"), a registered public utility holding company under the Public Utility Holding Company Act of 1935, as amended (the "PUHCA"). These replaced and superseded a previous plan which provided that the Company would remain an independent company. Pursuant to an Agreement and Plan of Merger, as amended (the "Merger Agreement"), and effective simultaneously with the effectiveness of the Plan, CSW Sub, Inc., a wholly-owned special purpose subsidiary of CSW ("CSW Sub"), would merge with and into the Company (the "Merger"), and CSW would become the owner of all of the issued and outstanding shares of common stock of the Company. On August 27, 1993, the Bankruptcy Court approved the Disclosure Statement and subsequently the Company solicited the approval of the various classes of creditors and security holders. At least 92% of those voting in each class of creditors or holders of interests voted in favor of the Plan. The remaining members of each class will receive the same treatment under the Plan as those voting in favor of the Plan. On December 8, 1993, the Bankruptcy Court entered an order confirming the Plan.

Conditions to Effectiveness of the Plan and Merger. The Merger Agreement and Plan contain numerous conditions to effectiveness, including but not limited to the following described conditions:

- (i) receipt of the regulatory approvals and determinations that, in the judgment of the Company and CSW, are reasonably required to implement the provisions of the Plan and consummate the Merger, see "Regulatory Aspects of the Plan and Merger" below;
- (ii) the absence of certain occurrences that could result in a material adverse effect on the Company or the prospects for the business of the Company or CSW;
- (iii) performance by the Company, CSW and CSW Sub of all covenants contained in the Merger Agreement; and
- (iv) receipt of an investment grade rating for certain series of publicly tradeable first and second mortgage bonds of the Company, as reorganized.

Other than certain regulatory or statutory approvals that may not be waived, CSW and the Company may waive all or any portion of any of the conditions to effectiveness of the Plan and Merger.

Regulatory Aspects of the Plan and Merger. Consummation of the Plan and Merger is conditioned on receipt of required regulatory approvals, including those discussed below. The effectiveness of the Plan is expressly conditioned upon obtaining Texas and New Mexico rate orders establishing certain ratemaking, accounting and regulatory treatments acceptable to CSW, unless this condition is waived by CSW and the Company.

EL PASO ELECTRIC COMPANY
(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)
NOTES TO FINANCIAL STATEMENTS - (Continued)

Public Utility Commission of Texas ("Texas Commission"). The effectiveness of the Plan and the Merger is conditioned upon the receipt of the following Texas regulatory approvals and determinations:

- (i) approval of a base rate increase of \$25 million for the Texas jurisdiction and determinations authorizing certain other ratemaking, accounting and regulatory treatments;
- (ii) determination that the Merger is in the public interest; and
- (iii) determination that the reacquisition by the Company of the portions of Units 2 and 3 at the Palo Verde Nuclear Generating Station ("Palo Verde" or "Palo Verde Station") which are subject to the leases (the "Palo Verde Leases") described in Note B is in the public interest.

The proposed Texas rate settlement plan offered by CSW and the Company proposes a Texas jurisdictional base rate increase of \$25 million for the Company effective in 1994. Subject to receipt of that increase and other acceptable accounting, ratemaking and regulatory treatments, the Company would agree not to seek a base rate increase in Texas to be effective prior to January 1, 1997, and no more often than every other year thereafter until the year 2001, subject to specified force majeure events.

New Mexico Public Utility Commission ("New Mexico Commission"). The effectiveness of the Plan and the Merger are conditioned on the receipt of the following New Mexico regulatory approvals and determinations:

- (i) approval of the Merger and any required authorizations or determinations related to operating as a public utility in New Mexico after the Merger;
- (ii) approval of a base rate increase of \$6 million for the New Mexico jurisdiction and determinations authorizing certain other ratemaking, accounting and regulatory treatments;
- (iii) approval of the issuance by the Company of the securities required for the consummation of the Plan; and
- (iv) approval, required under the New Mexico law on diversification by public utilities, of the transactions between the Company and CSW contemplated by either the Plan or Merger Agreement.

Nuclear Regulatory Commission ("NRC"). Approval of the NRC is required for the indirect transfer of control of the Company's interest in the Palo Verde operating licenses and amendment of those licenses to delete previously approved sale/leaseback arrangements.

Federal Energy Regulatory Commission ("FERC"). Approval of the FERC is required for the Company to, in effect, dispose of its interstate facilities through the Merger. Also, the FERC approval of other transactions contemplated under the Plan may be required, including the issuance and sale by the Company of new securities and the amendment of the CSW System Operating Agreement to include the Company as a party. The Company and CSW are seeking use of the transmission system of Southwestern Public Service Company, an electric utility based in Amarillo, Texas ("SPS"), to coordinate the operations of the Company and the CSW electric operating companies. The Company has requested that SPS agree to provide the transmission service and make the system modifications

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

necessary to accomplish such coordination. The Company and CSW have filed a request at the FERC seeking an order directing SPS to provide the requested service (and make the necessary system modifications). The Company expects SPS to oppose the issuance of such order.

Securities and Exchange Commission ("SEC"). As a registered public utility holding company subject to the PUHCA, CSW is required to obtain the approval of the SEC prior to consummating the Merger. Under the PUHCA, the SEC must find that after the Merger the Company and CSW will constitute an integrated electric system. As noted above, the Company and CSW propose to coordinate their operations by means of transmission service to be provided by SPS. In the past, the SEC has determined that integration may be effected by means of transmission rights on unaffiliated systems. SEC approval will also be required for the formation of CSW Sub, the issuance of CSW common stock to the holders of the Company's common stock and certain creditors, and the issuance of the Company's securities to holders of the Company's securities and certain creditors pursuant to the Plan.

Other Regulatory Filings. The Department of Energy ("DOE") must authorize persons to transmit electric energy from the United States. The Company holds an authorization to transmit electric energy to Comision Federal de Electricidad, the national electric utility of Mexico ("CFE"). DOE's approval is required for this authorization to be assumed by CSW.

The Company also must file a notice related to the Merger with the Federal Trade Commission and Department of Justice pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976. The applicable waiting period following such filing must have expired before the Effective Date of the Plan and Merger without an adverse ruling or other action with respect to any anticompetitive effects of the Merger.

Status and Timing. Certain of the above approvals have been requested and requests for other approvals are in process. The Company estimates that the process to obtain the above approvals would require up to 18 months, and perhaps longer. However, the Company can provide no assurance that all required approvals will be obtained or that the Plan and Merger will be consummated.

Consideration to Creditors and Security Holders. Under the Plan, existing creditors and existing equity security holders of the Company would receive for their claims cash and/or securities of the Company, as reorganized, and/or CSW or would have their claims cured and reinstated pursuant to the Bankruptcy Code. Shares of CSW common stock issued pursuant to the Plan would be subject to different lock-up periods, during which transfer would be restricted, depending on the class of creditor or interest holder.

Secured creditors generally would receive value equal to 100% of their allowed claim. Small unsecured creditors also would receive 100% of their allowed claim. Other unsecured creditors would receive 95.5% of the principal amount of their allowed claim.

The holders of claims under the Palo Verde Leases related to the bonds issued by two funding corporations to finance the purchase price in connection with the Company's sale/leaseback transactions of portions of Palo Verde (See Note B) would have their claims satisfied by issuance of securities equal to 95.5% of the amount of the allowed claim. The allowed claim is set at \$700 million under the Plan. In addition, the owner participants in the sale/leaseback transactions have entered into settlements with the Company of the pending adversary proceeding (See Note B) that is contingent on the Plan becoming effective. Pursuant to settlement agreements, on the Effective Date of the Plan all claims that were or might have been asserted against the Company by the Owner Participants or against the Owner Participants by the Company would be dismissed with prejudice by the Bankruptcy Court. Further, at the Effective Date of the Plan, all obligations of the Company

EL PASO ELECTRIC COMPANY

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NOTES TO FINANCIAL STATEMENTS - (Continued)

under the Palo Verde Leases and other documents related to the sale/leaseback transactions would be deemed satisfied and discharged, except for certain specified provisions such as indemnification obligations, as modified, and all right, title and interest in the property that was the subject of the sale/leasebacks would be vested in the Company.

Upon consummation of the Merger, shares of the Company's common stock outstanding immediately prior to the effective time of the Merger (other than any such shares which are held in the treasury of the Company or owned by CSW or CSW Sub) would be converted into the right to receive shares of CSW common stock. The conversion would be based on the ratio of the number of shares of CSW common stock credited to the CSW Common Stock Acquisition Fund (the "Fund") to the number of outstanding shares of the Company's common stock on the Effective Date of the Plan. The Fund is a system for tracking the consideration that would be paid to the Company's common shareholders in the Merger. No cash or shares of CSW common stock are actually placed in the Fund. At the Confirmation Date, 3,619,794 shares of CSW common stock were credited to the Fund based on (i) a value of \$3.00 per share of the Company's common stock; (ii) 35,544,330 shares of Company common stock outstanding on the Confirmation Date; and (iii) an average trading price of \$29.4583 for CSW common stock on the Confirmation Date. Additional shares of CSW common stock would be credited to the Fund with value up to \$1.50 per share of the Company's common stock outstanding on the Confirmation Date based on the resolution of certain contingent items described in the Merger Agreement as tangible and intangible assets and reductions in claims. In addition, shares of CSW common stock based on the dividends that would have been paid by CSW on the amounts credited to the Fund from the Confirmation Date to the Effective Date of the Plan will be credited to the Fund. The closing price for CSW common stock at March 15, 1994 was \$26.00 per share. As of March 15, 1994, 3,757,009 shares of CSW common stock have been credited to the Fund.

Pursuant to the Plan, the allowed interests of preferred shareholders would be the sum of the aggregate amount of the redemption prices of the preferred stock and the aggregate amount of prepetition dividends. These interests would be satisfied under the Plan by the issuance of securities having a value in the amount of \$68 million. Under the Plan, the Company's preferred stock would be converted to either preferred stock of the Company, as reorganized, or a combination of CSW common stock and preferred stock of the Company, as reorganized.

Interim Payments. In addition to the treatment of the prepetition claims of each class of creditors and security holders, as discussed above, the Plan provides for the Company to make certain payments at the Confirmation Date and thereafter until the Effective Date of the Plan. These payments are in addition to periodic interest payments on secured debt that the Company has been making since July 1, 1992 pursuant to orders of the Bankruptcy Court. The payments were negotiated as part of the process to achieve approval of the Plan and are intended to compensate certain holders of claims and interests during the period from the Confirmation Date to the Plan's Effective Date. These interim payments consist of (i) amounts characterized as interest on unsecured and undersecured debt and on the claims of the holders of the bonds related to the financing of the Palo Verde sale/leaseback transactions; (ii) amounts characterized as periodic payments to holders of the Company's preferred stock, which the Bankruptcy Court has ruled are not dividends; and (iii) fees of advisors and other expenses of the various classes of creditors and interest holders. The amounts paid under (i) and (ii) are calculated at variable rates, primarily at 90-Day LIBOR plus 2% (5.3% at December 31, 1993).

To the extent that liabilities and expenses related to these payments have been accrued by the Company since the filing for bankruptcy, the Company has reduced such liabilities by the interim payments. Otherwise, the interim payments have been expensed as interest or reorganization items. Accordingly, amounts aggregating approximately \$15.5 million through December 31, 1993, paid to the Palo Verde Leases bondholders have been offset against accruals which the Company has been recording on a regular basis; amounts aggregating approximately \$10.2 million through December 31,

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NOTES TO FINANCIAL STATEMENTS - (Continued)

1993, paid on unsecured debt for which the Company had not been accruing interest were charged to interest expense; and amounts aggregating approximately \$14.7 million through December 31, 1993, paid to holders of preferred stock as periodic payments and certain amounts of fees and expenses charged to reorganization items. The Company estimates that interim payments aggregating approximately \$15.4 million per quarter will be made through the Effective Date of the Plan, of which approximately \$9.2 million would be offset against amounts which the Company has been recording on a regular basis; \$5.3 million would be expensed as interest expense and \$900,000 would be expensed as reorganization items. These amounts are in addition to the monthly payments of approximately \$5 million on secured debt that the Company has been making and expects to continue to make.

The Plan provides for other amounts to be paid at only the Effective Date of the Plan representing interest on certain claims and fees incurred by certain classes, which are not included in the interim payments set forth in the Plan, as described above. These amounts are estimated to aggregate approximately \$14 million at December 31, 1993, of which approximately \$11 million has not been accrued by the Company because it is uncertain if the Plan will become effective. In addition, certain of the Company's advisors in the bankruptcy proceeding have petitioned the Bankruptcy Court for "success fees" related to the Plan. The success fees requested to date aggregate approximately \$7 million and if awarded by the Bankruptcy Court would become payable if the Plan becomes effective.

Termination of Merger Agreement. Each of the Company and CSW have the right to terminate the Merger Agreement in certain circumstances outlined in the Merger Agreement. In the event the Merger Agreement is terminated, it shall become void and, other than (i) the possible payment of a termination fee, by the Company or CSW to the other party; and (ii) under certain circumstances, the reimbursement to the Company by CSW of certain costs, interest and expenses related to the Merger borne by the Company, there is no other obligation or liability on the part of the Company, CSW or CSW Sub. Termination fees of \$25 or \$50 million (in the case of any payments due from the Company to CSW) or \$25 million (in the case of any payment due from CSW to the Company) are payable only in limited circumstances. The amount of the termination fee payable by the Company, if any, depends on the reason for termination.

Alternatives to the Plan. If the Plan does not become effective, the Company would consider other alternatives to the Merger including a merger or business combination with another entity or entities and reorganizing as an independent company. It is also possible that the Bankruptcy Court would allow a third party to file a plan of reorganization for the Company and such plan could involve a merger, business combination or acquisition. Although it has indicated it is undesirable, if no other plan or reorganization is viable, the Bankruptcy Court could order the liquidation of the Company. Any plan of reorganization other than the Plan would provide for different treatments of the claims of the creditors and security holders than those set forth in the Plan. The Company cannot predict what such treatments would be, in what respects actions proposed under the Plan would be modified, or the amount of time that would be involved before any alternate plan would become effective. The Company is considering what alternatives would be available in the event the Plan does not become effective.

B. Sale and Leaseback Transactions and Letters of Credit Draws

In August and December 1986 and December 1987, the Company consummated ten separate sale/leaseback transactions involving all of its 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. Pursuant to applicable agreements, the Company remains responsible, during the terms of the Palo Verde Leases, for all operating and maintenance costs, nuclear fuel costs, other

EL PASO ELECTRIC COMPANY

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NOTES TO FINANCIAL STATEMENTS - (Continued)

related operating costs of the leased-back facilities, and for decommissioning costs. Under their terms, the leases related to Unit 2 and Common Plant expire in October 2013, while the leases related to Unit 3 expire in January 2017. All of the Palo Verde Leases contain certain renewal options and provide for repurchase options, at fair market value, at the termination of the lease. See Note A for a discussion of the treatment of the Palo Verde Leases under the Plan.

The aggregate consideration received by the Company in the sale/leaseback transactions was \$934.4 million (\$684.4 million in 1986 and \$250 million in 1987). Nine of the ten transactions are accounted for as operating leases; one transaction (sales price of \$87.4 million) is accounted for as a financing transaction. For the transactions accounted for as operating leases, the proceeds exceeded the cost of the assets sold by \$194 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.

All of the Palo Verde Leases and related documents 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 (secured by letters of credit) which may exceed the equity investor's unrecovered equity investment. The Palo Verde Leases also contain provisions related to the indemnification of the lessors in certain circumstances against certain losses, including the loss of certain tax benefits, resulting from specified events.

The letters of credit related to the Unit 2 leases had expiration dates of December 31, 1991 and January 2, 1992. During the second half of 1991, the Company pursued a comprehensive financial restructuring which would have provided, among other things, for the issuance of required replacement letters of credit by December 1, 1991, the earliest date required pursuant to the leases. However, the Company failed to provide the replacement letters of credit by such date. On December 26 and 27, 1991, beneficiaries holding the letters of credit issued on the account of the Company in connection with the Unit 2 sales and leasebacks drew and were paid the full available amount of such letters of credit of approximately \$208 million. As discussed in Note A, the Company filed its bankruptcy petition on January 8, 1992. On January 9, 1992 the beneficiaries of the letters of credit issued in connection with the Unit 3 sale and leaseback transactions also drew and were paid the full available amount of such letters of credit of approximately \$80.4 million.

As a consequence of the letters of credit draws, the Company incurred direct obligations totaling approximately \$288.4 million to the letters of credit banks. The obligations are unsecured prepetition claims of the banks (see Notes A and H). The banks are precluded from taking any action to collect their claim against the Company outside of the Bankruptcy Case and the Company is presently precluded from paying the amount as a result of the bankruptcy filing. The Company has not made lease payments on Palo Verde Units 2 and 3 and the non-payment of rent by the applicable grace period provided in the Palo Verde Leases constitutes events of default under the leases, which ordinarily would entitle the lessors to various remedies pursuant to the terms of the applicable agreements, including, rescission or termination of the leases and liquidated damages. As a result of the bankruptcy filing, however, the lessors are stayed for exercising any remedies under the Palo Verde Leases except through the Bankruptcy Case. In connection with the Bankruptcy Case, the lessors and the holders of bonds issued to finance the lessors' purchase of the interests in Palo Verde have filed proofs of claims that collectively assert damages of approximately \$743.1 million.

On September 9, 1992, the Company filed an adversary proceeding against the lessors and the indenture trustees of the lease obligation bonds. The Company sought a declaratory judgment that the Palo Verde Leases are leases of real property under the Bankruptcy Code, and therefore (i) the leases were rejected pursuant to the Bankruptcy Code and (ii) the Company's liability for damages resulting from the rejection of the leases is limited to approximately \$273 million. In addition, the Company sought a declaratory judgment that its liability for lease rejection was fully satisfied by the

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NOTES TO FINANCIAL STATEMENTS - (Continued)

proceeds of \$288.4 million in letters of credit provided by the Company in connections with the leases. On December 15, 1992, the Bankruptcy Court granted partial summary judgment against the Company with respect to one issue on lease rejection damages, holding that the proceeds of the letters of credit do not satisfy or offset the maximum claim allowable in the event the leases were determined to be real estate leases. The Bankruptcy Court suspended further consideration of the other issues related to the proceeding and directed the parties to the litigation to seek a consensual resolution of the issue. On May 26, 1993, the Bankruptcy Court vacated its partial summary judgment.

The defendants in the adversary proceeding have asserted other claims against the Company, including claims for prepetition rent, postpetition rent, and fees and expenses incurred in connection with the Bankruptcy Case. In addition, the indenture trustees have alleged that if the Palo Verde Leases are leases of real property under the Bankruptcy Code, then the purchasers of the lease obligation bonds were defrauded by the Company. The Company denies those allegations.

The ultimate impact of this litigation on the financial position of the Company is dependent upon the terms of the plan of reorganization that becomes effective and the resulting rate treatment afforded (neither of which can be determined at this time). Accordingly, no provision has been made in the Company's financial statements. In the absence of a resolution of the nature and disposition of the Palo Verde Leases, the Company is continuing to accrue the cost of, but is not paying, the contractual rental rates (see Note H). See Note A regarding the treatment of the Palo Verde Leases proposed under the Plan and interim payments made to the bondholders pursuant to the Plan.

During 1993, 1992 and 1991, contractual lease requirements including amortization of transaction costs under the Palo Verde Leases accounted for as operating leases amounted to approximately \$83.1 million, \$83.2 million and \$84.1 million. Future contractual minimum annual rental payments required under such leases are as follows (In thousands):

**Year Ending
December 31**

1994	\$ 82,757
1995	82,757
1996	82,757
1997	82,757
1998	82,757
Thereafter	1,291,777

The table does not reflect any of the potential effects upon future contractual rental payments that would result from the Plan becoming effective.

C. Rate Matters

Overview

Effect of Bankruptcy on Regulation. The Bankruptcy Code provides that the Bankruptcy Court shall confirm the Company's plan of reorganization only if "any governmental regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor has approved any rate change provided for in the plan, or such rate change is expressly conditioned on such approval." To date, the Company has not asserted arguments in the regulatory proceedings that the provisions of the Bankruptcy Code, together with applicable provisions of other federal statutes, grant the Bankruptcy Court the authority to preempt otherwise applicable regulatory authority and processes, and it is uncertain whether the Company would prevail on such arguments, if asserted. As discussed in Note A above, the Company or, where appropriate, CSW or APS, have filed or will file applications with

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various regulatory bodies to seek approvals or findings necessary to consummate the Merger and otherwise satisfy the conditions to the effectiveness of the Plan. The discussions of the applications filed or to be filed before the regulatory bodies pursuant to the Plan and the pending regulatory appeals discussed below in "Texas Rate Matters" and "New Mexico Rate Matters" should be read in the context of the preemption issue discussed above.

On June 11, 1992, an agreed order was entered in the Bankruptcy Court pursuant to which appeals in Dockets 7460, 8588, and 9165 (discussed below in "Texas Rate Matters") may go forward in state court and, upon remand, before the Texas Commission. The agreed order provided that it was not a determination of the applicability of the automatic stay in bankruptcy as to any other regulatory appeal or a determination of the jurisdiction of the Bankruptcy Court or any other court or regulatory authority with respect to the Company's rates or service. On September 20, 1993, the Bankruptcy Court entered an order lifting the automatic stay in the appeals of the Company's other Texas rate proceedings, consisting of Dockets 9945, 8018, 8078, 8363, and 9069 (discussed below in "Texas 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 largest municipality in the Company's service area in Texas is the City of El Paso. 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.

The Texas Commission has jurisdiction to grant and amend certificates of convenience and necessity ("CCN") for service territory and certain facilities, including generation and transmission facilities. Although the Texas Commission does not have the authority to approve transfers of utility assets, it is required to evaluate certain transfers of utility assets and mergers and consolidations of regulated utility companies to determine if those transactions are consistent with the public interest. Upon a finding that such a transaction is not in the public interest, the Texas Commission is required to consider the effects of the transaction in future ratemaking proceedings and is required to disallow the effects of the transaction if it will unreasonably affect rates or service.

New Mexico. The New Mexico Commission has jurisdiction over the Company's rates and services in New Mexico. The New Mexico Commission must grant prior approval of the issuance, assumption or guarantee of securities; the creation of liens on property located within the state; the consolidation, merger or acquisition of some or all of the stock of another utility; and the sale, lease, rental, purchase or acquisition of any public utility plant or property constituting all or part of an operating unit or system. The New Mexico Commission also has jurisdiction as to the valuation of utility property and business; certain extensions, improvements and additions; Class I and II transactions (as defined by the New Mexico Public Utility Act); abandonment of facilities and the certification and decertification of utility plant.

Federal Energy Regulatory Commission. The Company is subject to regulation by the FERC in certain matters, including rates for wholesale power sales and the issuance of securities. In 1992, the Congress enacted the Energy Policy Act, which, among other things, removes certain restrictions on utility participation in the competitive wholesale generation market. In addition, subject to certain limitations, the legislation provides that the FERC also may order electric utilities, including the Company, to provide certain transmission services. The legislation also expands the authority of state utility commissions to examine the books and records of electric utilities.

Nuclear Regulatory Commission. The Palo Verde Station is subject to the jurisdiction of the NRC, which has authority to issue permits and licenses, to regulate nuclear facilities in order to protect the health and safety of the public from radiation hazards and to conduct environmental

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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 at Palo Verde for terms of forty years each, beginning December 31, 1984, December 9, 1985 and March 25, 1987, respectively. Full power operating licenses for Units 1, 2 and 3 were issued by the NRC in June 1985, April 1986 and November 1987, respectively. In addition, the Company (along with the other Palo Verde Participants other than APS) is separately licensed by the NRC to own its proportionate share thereof. On January 13, 1994, APS, as Operating Agent of Palo Verde, joined by the Company, filed a request with the NRC (i) for consent to the indirect transfer of the Company's possession and ownership in the Operating Licenses for Palo Verde Units 1, 2 and 3 that will occur as a result of the merger of a special-purpose subsidiary of CSW with and into the Company; and (ii) to amend the Operating Licenses for Units 2 and 3 to delete provisions of those licenses related to the Company's sale and leaseback transactions involving those units. The request to the NRC specifies that the requested amendments to the Operating Licenses and consent become effective on the Effective Date, upon notification by the applicants that all necessary regulatory approvals have been obtained, but the Company cannot predict at this time whether and when the approvals and consent will be granted. See Note A above.

Accounting for the Effects of Regulation. Prior to December 31, 1991, the financial statements of the Company were prepared pursuant to the provisions of Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 71, as amended, "Accounting for the Effects of Certain Types of Regulation," which provides for the recognition of the economic effects of regulation. In early 1992, the Company determined that there existed substantial doubt concerning whether the criteria for reflecting the economic effects of regulation continued to be met as a result of continuing cash flow problems arising from inadequate rate relief and the uncertainty surrounding regulation during the reorganization process, including the regulatory treatment, if any, of the \$288.4 million letters of credit draws. The Company concluded that it was not reasonable to assume that its rates were, or will be, without giving consideration to possible outcomes of the reorganization process, designed to recover its costs on a timely basis. Because of the uncertainty of the nature of any reorganization plan ultimately consummated and the assessment of the nature of regulation, the Company concluded that it did not then and does not currently have sufficient assurance to reflect the economic effects of regulation in its general purpose financial statements. Therefore, as required by generally accepted accounting principles, the Company eliminated from its 1991 balance sheet the aggregate effects of regulation, which resulted in a \$311 million extraordinary charge to results of operations for the year ended December 31, 1991. This amount included approximately \$200 million of operating expenses primarily related to Palo Verde and approximately \$80 million of income taxes related to the Palo Verde sale/leaseback transactions which had been deferred by the Company's regulators for recovery in future periods. Furthermore, the Company did not record the letter of credit draws amounting to \$288.4 million as an asset and has not recorded any new assets reflecting the economic effects of regulation since 1991 in its general purpose financial statements.

Although the outcome of the reorganization process cannot presently be determined, the Company believes that the rates established in conjunction with any reorganization plan will be designed to recover the Company's costs, including a return on equity, after the establishment of an appropriate capital structure, as well as to reflect other changes that may result from the reorganization. The Company expects that, upon effectiveness of any plan of reorganization, its regulated operations will meet the SFAS No. 71 criteria necessary to reflect the effects of regulation in its general purpose financial statements. Such rates may include the recovery of some or all items that, at that time, are not reflected as regulatory assets on the Company's general purpose financial statements. However, in the absence of application of purchase accounting applied in the event of a change in control occurring as part of the reorganization, there does not appear to be any applicable accounting precedent for the restoration of such amounts as assets created prior to the re-adoption of SFAS No. 71. Restoration of such amounts as assets will depend upon a number of factors, including

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intervening developments in accounting standards and other accounting literature, the outcome of which cannot currently be determined. In March 1993, the Financial Accounting Standards Board's Emerging Issues Task Force reached a consensus that if a rate-regulated enterprise initially fails to meet the regulatory asset recognition requirements of SFAS No. 71, but meets those requirements in a subsequent period, then regulatory assets should be recognized in the period the requirements are met. Although the Emerging Issues Task Force's consensus applied to rate-regulated enterprises currently meeting the requirements of SFAS No. 71, the Company believes that this consensus supports the Company's position regarding restoring previous net regulatory assets in its general purpose financial statements. In the event it is concluded that such restoration is not appropriate under generally accepted accounting principles, the Company would be precluded from recognizing historical amounts as regulatory assets in its general purpose financial statements. If it is determined that such restoration is appropriate, regulatory assets would be recorded to the extent items allowed to be recovered in the rate making process have not been reflected as assets in the Company's general purpose financial statements.

Texas Rate Matters

Rate Moderation Plan - Palo Verde Units 1 and 2. In 1988 the Texas Commission established a rate moderation plan in Docket 7460 based on a contested stipulation, pursuant to which the Texas jurisdictional portion of the Company's investment in Palo Verde Unit 1, Common Plant, and lease payments on Unit 2 (to the extent of approximately 83% of those lease payments) were to be phased-in to rates in four steps. The order in Docket 7460 also settled all issues concerning the prudence of the Company's initial decision to participate in Palo Verde and all issues concerning prudence in the construction of Units 1 and 2. (The prudence of the Company's decision to continue its investment in Unit 3 after 1978 and the prudence in the construction of Unit 3 were the subject of Docket 9945, discussed below.) The Docket 7460 order was upheld by the Texas Court of Appeals for the 3rd Judicial District at Austin, Texas (the "Court of Appeals"), on August 26, 1992, except for a determination that deferred carrying costs may not be included in rate base. The case has been appealed to the Texas Supreme Court by the Company and other parties. See discussion below under "Deferred Accounting Cases."

The first base rate increase contemplated under the rate moderation plan was ordered in Docket 7460, and the remaining three increases were sought and ordered in subsequent rate filings (Dockets 8363, 9165, and 9945). As a result of these filings, the Texas Commission has allowed periodic rate increases which allow the Company to recover some, but not all, of its revenue requirements associated with its investment in Units 1 and 2 (as established in these rate cases), and the Company has been permitted to defer those unrecovered revenue requirements on its regulatory books of account for collection in later years. In Docket 9945, the Texas Commission limited each future base rate increase intended to recover those deferrals to 3.5%. In connection with the Company's discontinuation of reporting under SFAS No. 71 as of December 31, 1991, approximately \$46.1 million of "phase-in deferrals" previously recorded pursuant to this plan have been eliminated from the Company's general purpose financial statements and reported as part of the extraordinary charge to results of operations for the year ended December 31, 1991.

Dockets 8363 and 9165 have been appealed to the Texas District Court, where the appeals remain pending. A hearing on the appeal of Docket 8363 has been scheduled for July 1994. No hearing on the appeal of Docket 9165 has been scheduled. The outcome of these appeals and the results or materiality of final dispositions of these cases presently cannot be determined.

Docket 9945. On December 28, 1990, the Company filed with the Texas Commission a combined request for the scheduled fourth base rate increase under the Docket 7460 rate moderation plan discussed above and for the recovery, also on a moderated basis, of the Texas jurisdictional portion of

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the Company's investment in Palo Verde Unit 3, including the lease payments, net of deferred gain, on the Company's sales and leasebacks of a portion of its interest in Unit 3. The Company's combined request was for \$131.3 million, which included approximately \$49 million related to the Units 1 and 2 rate moderation plan and approximately \$82.3 million related to Unit 3. Of the total request, approximately \$38 million was to be in cash with the balance deferred for subsequent recovery.

The Texas Commission issued its final order in Docket 9945 on November 12, 1991, approving a total increase in Texas base revenues of approximately \$47 million, consisting of \$37 million in cash and \$10 million of phase-in deferrals. The order approved a cash increase of approximately \$7 million as the fourth increase under the Units 1 and 2 rate moderation plan with a phase-in deferral of \$10 million for future recovery in rates. The order limited each future increase in base rates under the Units 1 and 2 plan to 3.5%, but also approved a regulatory non-cash revenue adjustment recommended by the Hearing Examiners, which was necessary to provide for full recovery of the phase-in deferrals during the remaining term of the Units 1 and 2 rate moderation plan. The balance of the \$37 million cash increase (approximately \$30 million) represented operating and maintenance expenses, decommissioning expenses and ad valorem taxes on Unit 3 of Palo Verde, as well as an allowance for purchased power capacity. The balance did not include any current return of or return on the owned portion of Unit 3 or recovery of the lease expenses related to Unit 3. Recovery of these costs has been held in abeyance to be included subsequently in Texas rates over a scheduled period of time, as discussed below.

The Texas Commission disallowed approximately \$32 million of Unit 3 capitalized costs, on a total Company basis, as imprudently incurred. The order also disallowed \$9.8 million, on a total Company basis, of previously deferred costs related to the 1989-90 outages of Units 1 and 2. The Company recorded pre-tax write-offs of \$24.1 million and \$6.3 million, respectively (the Texas jurisdictional amounts of these disallowances), in results of operations in the third quarter of 1991.

With respect to the rate treatment of Unit 3, the Texas Commission adopted an inventory plan, pursuant to which the Company's investment in Unit 3 was neither included in rates nor expressly disallowed, but instead held in abeyance to be included subsequently in Texas rates over a scheduled period of time. In justifying the inventory plan, the Texas Commission found (i) the Company was imprudent in not attempting to sell a portion of its interest in Palo Verde between 1978 and 1981; (ii) the Company failed to demonstrate that it would not have been unable to sell such interest if it had attempted to do so; and (iii) as a result of such imprudent action, the addition of Unit 3 to the Company's system would result in excess capacity. However, the Texas Commission further found that Unit 3 would become "used and useful" to the Texas jurisdiction in the following percentages: 0% (in Docket 9945), and 40%, 65%, 85% and 100% thereafter. It is the Company's position that the successive phases of the inventory plan were to be implemented on an annual basis; however, other parties may contest that position. Other parties also may contest whether the inventory plan constituted a proper determination by the Texas Commission of when Unit 3 would become used and useful. During the period Unit 3 is held in inventory, the Company will recover the operating and maintenance expenses, decommissioning expenses and ad valorem taxes associated with Unit 3, along with an allowance for purchased power capacity. Pursuant to the order, but subject to possible changes that could result from an effective reorganization plan, the Company expects to recover, in future years, the following at the applicable inventoried percentages: a return of and on the plant costs associated with the owned portions of Unit 3 and the amount of lease payments due under the sale/leaseback transactions the Company entered into in connection with Unit 3. Under the order, the Company will retain the benefits of its sales to CFE for at least the period covered by the first rate order under the inventory plan.

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The Company disputes there was any imprudence, either in connection with the Unit 3 capitalized costs or in retaining its full investment in Palo Verde. The Company challenged both aspects of the Texas Commission's order in the Company's Motions for Rehearing and has continued such challenges on appeal. The Company filed an appeal with the Texas District Court on April 21, 1992. The City of El Paso and two intervenors also appealed. On October 27, 1993, the Texas District Court affirmed the final order of the Texas Commission except in two respects. The Texas District Court held the Texas Commission erred (i) by refusing to include certain disallowed utility expenses as deductions when computing federal income tax expense for ratemaking purposes and (ii) by granting rate base treatment for post-in-service deferred carrying costs associated with Palo Verde. The second holding is consistent with the decision of the Texas Court of Appeals in Docket 7460, discussed below under "Deferred Accounting Cases." The Company has appealed the decision, as have the City of El Paso and the two intervenors who were parties to the appeal before the Texas District Court. The ultimate outcome of the appeals and their results or the materiality thereof cannot be predicted at this time.

Deferred Accounting Cases. The Company has received a series of orders authorizing the deferral of operating costs incurred, and carrying charges accrued, on each unit of Palo Verde between the unit's in-service date and the date of its inclusion in Texas rates. Certain orders have also permitted the Company to include in rate base and amortize the deferred costs over the lives of Units 1 and 2 (approximately 40 years for ratemaking purposes). All of these "deferred accounting orders" have been appealed. The ultimate outcome of these appeals and their results or the materiality thereof cannot be predicted by the Company at this time.

The deferred accounting order in Docket 7460 (regarding Units 1 and 2) has been the subject of two rulings by the Court of Appeals and is currently pending before the Texas Supreme Court. In its first ruling on August 14, 1991, the Court of Appeals held that none of the deferred costs could be included in rate base. As a result of that ruling, the Company discontinued deferring for financial reporting purposes Unit 3 operating and maintenance expenses and related carrying costs as of July 1, 1991. The Company and other parties filed Motions for Rehearing, in response to which the Court of Appeals issued a subsequent ruling on August 26, 1992, holding that deferred operating costs may be placed in rate base. Although the Court of Appeals maintained its position that deferred carrying costs may not be included in rate base, it stated that its opinion did not preclude the recovery of carrying costs without rate base treatment. This would allow recovery of the carrying costs, but might not allow the Company to earn a return on the unamortized balance of those carrying costs. The Company estimates that the amount of return on such carrying costs previously included in revenue requirements authorized by the Texas Commission, on an unmoderated basis, is approximately \$33.4 million as of March 31, 1994. The Texas Supreme Court granted writ of error with respect to the issue of the propriety of deferred accounting orders and heard oral argument on the case on September 13, 1993 (along with three similar appeals involving other Texas electric utilities). The Texas Supreme Court has not issued its ruling on the appeals. If the Court of Appeals' decision is upheld by the Texas Supreme Court and remanded to the Texas Commission, it is possible that the return on the deferred carrying costs will not be refunded, but will instead be offset against the balance of unamortized phase-in deferrals. It is also possible that the Texas Commission could find that the inability to earn a return on deferred carrying costs has increased the Company's risk and could, correspondingly, adjust the Company's allowed rate of return such that the previously determined total revenue requirement would remain unchanged.

In connection with the Company's elimination of net regulatory assets from its balance sheet as of December 31, 1991, approximately \$94 million of Units 1 and 2 accounting deferrals and \$60.3 million of Unit 3 accounting deferrals have been eliminated and reported as part of the extraordinary charge to results of operations for the year ended December 31, 1991. If the Court of

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Appeals decision is upheld and assuming no refund will be required (as discussed above), there will be no additional write-offs required in the Company's general purpose financial statements.

Rate Case Expenses Incurred in Docket 7460. The issue of recovery of expenses incurred by the Company and the City of El Paso in connection with Docket 7460 was severed from the issues ruled upon by the Texas Commission in that Docket and was assigned to a new Docket 8018 for consideration. On September 20, 1991, the Texas Commission issued its final order in the case and approved the reimbursement of approximately \$10.8 million for expenses incurred by the Company and approximately \$1.1 million for expenses incurred by the City of El Paso. The Texas Commission further directed that such amounts be surcharged to the Company's Texas customers over a one-year period, which the Company completed in November 1992. The City of El Paso filed an appeal of the Texas Commission's order in Docket 8018 with the Texas District Court, and oral arguments were held March 18, 1994. After hearing arguments, the Texas District Court affirmed the Texas Commission's decision. Further appeals by the City of El Paso are possible. The ultimate outcome of any such appeal and its result or the materiality thereof cannot be predicted at this time.

In connection with the Company's elimination of net regulatory assets from its balance sheet as of December 31, 1991, the unrecovered balance of all rate case expenses previously deferred, including cases other than Docket 7460, was eliminated. The Company expects that all of these costs ultimately will be collected in full from its Texas customers.

Texas Recognition of Palo Verde Sales and Leasebacks. In its Docket 8363 order and a separate order issued in August 1989 (Docket 8078), the Texas Commission found the Company's Unit 2 and Unit 3 sales and leasebacks to be in the public interest. The rulings, if upheld on appeal, would ensure that the Texas Commission will consider those transactions in connection with the Company's rate cases. The finding on the Unit 2 sales and leasebacks, in addition to findings regarding federal income tax expense and other ratemaking issues, is a part of the City of El Paso's appeal of the Docket 8363 order. The City of El Paso appealed the Texas Commission's order in Docket 8078 with respect to the Unit 3 transactions to the Texas District Court. A hearing on the appeal of Docket 8078 has been scheduled for August 1994. While the Company believes that the Texas District Court will uphold the Texas Commission's orders, the ultimate outcomes of the appeals and their results or the materiality thereof cannot be predicted with certainty at this time.

Performance Standards for Palo Verde. In 1991, the Texas Commission established performance standards in Docket 8892 for the operation of the Palo Verde units. Each Palo Verde unit included in Texas rates is evaluated annually to determine if its three-year rolling average capacity factor entitles the Company to a reward or a penalty. There are five performance bands based around a target capacity factor of 70%. Neither a penalty nor a reward would result from capacity factors from 62.5% to 77.5%. Capacity factors are calculated as the ratio of actual generation to maximum possible generation. If the capacity factor for any unit is 35% or less, the Texas Commission is required to initiate a proceeding to determine whether such unit should continue to be included in rate base.

The performance standards are effective as of the date each unit is included in Texas rates, which was April 22, 1988 for Units 1 and 2. In June 1993, the Company filed its third annual performance report with the Texas Commission. The Company incurred neither a penalty nor a reward for the 1993 report. The three-year capacity factor was 72.9% for Unit 1 and 75.2% for Unit 2. The Company expects the report to be filed with the Texas Commission in 1994 to reflect performance for Units 1 and 2 resulting in neither a penalty nor a reward, though the projected capacity factor for Unit 2 is projected to be only slightly above the point at which a penalty could be incurred.

Recovery of Fuel Expenses. The Company recovers fuel and purchased power costs from its Texas customers pursuant to a fixed fuel factor established by the Texas Commission. Fuel revenues

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collected under the fixed fuel factor must be periodically reconciled to costs allowed by the Texas Commission. The Company's last reconciliation, Docket 8588, was for the period August 1, 1985 through March 31, 1989, and involved over \$200 million in Texas fuel costs. The final order issued in 1990 required a refund of approximately \$7.1 million, plus interest, which the Company completed over a twelve-month period beginning in February 1991. The Company and the City of El Paso appealed the Texas Commission's order in Docket 8588 to the Texas District Court. On November 25, 1991, the Texas District Court entered judgment on the appeals, upholding the Texas Commission's order on all points except the Company's appeal of the treatment of certain purchased power capacity costs during 1985-86. With regard to those costs, totaling approximately \$4.2 million, the Texas District Court held that the Texas Commission erred in failing to justify adequately its decision not to allow the Company to recover such costs through its reconcilable fuel account. The Texas District Court remanded the case to the Texas Commission with instructions to reconsider the allowance of such costs. Both the Texas Commission and the City of El Paso appealed the Texas District Court's decision to the Court of Appeals. On March 10, 1993, the Court of Appeals affirmed the decision of the Texas District Court. On February 2, 1994, the Texas Supreme Court denied the applications for writ of error filed by the City of El Paso and the Texas Commission. The case will be remanded to the Texas Commission for a new hearing to address whether the Company should be allowed to include the purchased power capacity charges as reconcilable fuel costs and recover such costs. The ultimate outcome of this hearing cannot be predicted at this time.

On January 26, 1993, the Texas Commission adopted a new fuel rule allowing for adjustment of the fixed fuel factor every six months on a prescribed schedule and requiring reconciliation of fuel costs and revenues whenever three years of fuel data have accumulated. Under the new rule, both refunds and surcharges are allowed without changing the fixed fuel factor where the cumulative over- or under-recovered fuel balance, including interest, is greater than or equal to 4% of the estimated annual fuel costs adopted most recently by the Texas Commission. The Texas Commission is required to act on a petition to change a fixed fuel factor within sixty or ninety days, depending on whether a hearing is required. The Company is allowed under the prescribed schedule to petition for a change in its Texas fixed fuel factor in January and July of each year under the new rule.

Ratemaking Treatment of Federal Income Taxes. In a 1987 case involving an electric utility, the Texas Supreme Court determined that, under certain circumstances, it is appropriate to allow only "actual taxes incurred" for ratemaking purposes. The Court of Appeals has applied the Texas Supreme Court decision to another utility, *Public Utility Commission of Texas v. GTE-Southwest*, 833 S.W.2d 153 (Tex. App. - Austin 1992, writ granted). The Texas Supreme Court heard oral argument in that case in September 1993 and has not ruled yet.

Additionally, the Texas Commission has recently applied various forms of the "actual taxes incurred" methodology in rate proceedings involving other utilities. There is significant uncertainty as to the application of the methodology used in those proceedings. The Texas Commission historically had granted rates that included an income tax component based on a "stand alone basis" and on the utility's allowed return on equity. The Texas Commission has now altered this policy. The appeals related to Dockets 8363 and 9945 include claims that the Texas Commission failed to adhere to the "actual taxes incurred" methodology in setting the federal income tax expense component of the Company's rates. As a result, any remand of Dockets 7460, 8363, 9165 or 9945 to the Texas Commission could include a reconsideration of the respective federal income tax components, which were based on the "stand alone" methodology previously used by the Texas Commission.

Depending on the outcome of any such remand, the Company may be required to refund certain amounts collected in rates since 1988. The likelihood and amount of any refunds are uncertain at this time because the ultimate outcome of the pending appeals is unknown, and the Company cannot predict the result of any remand.

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Texas Rates Proposed in the Plan of Reorganization. The Company filed on January 10, 1994, for its fifth increase under the terms of the Rate Moderation Plan ordered by the Texas Commission in Docket 7460, and a base rate increase under the inventory plan for Palo Verde Unit 3 established in Docket 9945. The proposed rate changes represent what the Company believes is supported under Texas law and prior Texas Commission orders, adjusted to reflect its proposed acquisition by CSW. The filing is proceeding under Docket 12700.

The total amount of the Company's requested cash base rate increase, exclusive of fuel, in the filing is approximately \$41.4 million. The total increase consists of (i) a base rate increase of \$8.3 million, constituting the proposed 3.5 percent increase contemplated under the Rate Moderation Plan for costs other than those associated with Palo Verde Unit 3; and (ii) a base rate increase of \$33.1 million, constituting the proposed increase under the inventory plan for Palo Verde Unit 3. As discussed below, CSW has made a contemporaneous settlement offer that proposes rates lower than those reflected in the Company's rate filing.

In the Docket 12700 proceeding, the Company has further proposed to reconcile its Texas fuel costs and revenues for the period from April 1989 through June 1993 and to decrease its current average fixed fuel factor. The proposed decrease in the average fixed fuel factor is anticipated to a decrease annual fuel revenues by approximately \$14.3 million. As a result of the fuel reconciliation and treatment of other fuel-related items, the Company has accrued in its financial statements and proposes to refund to Texas jurisdictional customers (as a credit to fuel revenue collections) approximately \$16.4 million over a 12-month period. In addition, the Company proposes to recover from Texas jurisdictional customers over a 12-month period a rate case expense surcharge of approximately \$8.7 million. The net effect of the proposed changes, together with the requested rate increases, would be an approximate \$19.4 million increase in revenues from Texas jurisdictional customers for the first 12-month period the changes are in effect.

The Company has not included in the rate filing a request to recover the costs of bankruptcy reorganization or the \$288.4 million from the draws on the letters of credit related to the Company's sale and leasebacks of portions of its interest in Palo Verde, which draws occurred in late December 1991 and early January 1992. The Company has sought to reserve the ability to seek recovery of such costs if the Plan does not become effective.

In addition to the Company's rate filing, the Company and CSW filed on January 10, 1994, a Joint Report and Application (the "Texas Merger Application") with the Texas Commission requesting (i) a determination that the acquisition by CSW of one hundred percent of the Company's common stock is consistent with the public interest; and (ii) certain determinations regarding the regulatory treatment of the Company's proposed reacquisition of the portions of Palo Verde that it previously sold and leased back.

As part of the Texas Merger Application and as a basis of settlement, CSW proposes rates for Texas jurisdictional customers of the Company that are substantially less than those reflected in the Company's rate case filing. The CSW settlement offer is contingent on the determination by the Texas Commission that CSW's acquisition of the Company is consistent with the public interest and the other regulatory determinations and approvals requested in the Texas Merger Application. The proposed settlement offers (i) to limit the non-fuel base rate increase for Texas jurisdictional customers to \$25 million; (ii) a proposed \$12.8 million reduction in fixed fuel factors; (iii) a refund of \$16.4 million over a 12-month period of over-recovered fuel costs and other fuel-related items; and (iv) a rate case expense surcharge of \$4.1 million related to previous rate cases to be collected over a 12-month period. Taking into account the annual reduction in fuel costs and the proposed fuel refund, the Company's revenues from Texas jurisdictional customers would not increase during the first year after the rate

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change goes into effect. The settlement rate plan proposed by CSW also provides for (i) a freeze in the effectiveness of any additional base rate increase until 1997; (ii) a limitation in the frequency of base rate increases following the rate freeze period through 2001 to not more than once every other year (i.e., 1997, 1999 and 2001); and (iii) a limitation on the amount of the 1997, 1999 and 2001 base rate increases, such that each increase would not exceed eight percent of total revenues.

The Company expects the City of El Paso and some intervenors in Docket 12700 will contest both the Merger and the proposed rate increase. However, at this time, the City of El Paso has taken no official action in opposition to or support of the Merger or requested rate increase. The Company anticipates the number of intervenors will be greater than in a typical rate filing. SPS and other Texas utilities have filed motions to intervene. The Company cannot predict at this time whether the settlement proposal will be adopted by the Texas Commission as proposed or whether the Texas Commission will enter the requested findings in connection with the Texas Merger Application. The Texas Merger Application has been consolidated with Docket 12700. The presiding officers approved a stipulation under which hearings in the consolidated proceeding will begin in late July 1994. The Company will be entitled to increase its rates under bond in mid-July 1994, subject to refund depending on the final outcome of the proceeding. The Company has not determined what level of increase would be implemented under bond, should it choose to do so. The Company anticipates a final order will be issued in Docket 12700 during the first half of 1995.

New Mexico Rate Matters

Rate Moderation Plan-Palo Verde. In 1987, the New Mexico Commission approved a stipulation in Case 2009 establishing a rate moderation plan, pursuant to which the New Mexico jurisdictional portion of the Company's interest in Unit 1 and one-third of common plant, and approximately 83% of the lease payments on Unit 2 and the related common plant were phased-in to rates in three steps. After the third step of the phase-in, the plan froze New Mexico rates through December 31, 1994. The Company agreed that it will not request rate base or cost of service treatment, or other rate recognition, for Unit 3 and its related Common Plant.

The Company will be required to recover the New Mexico jurisdictional portion of the Company's investment in Unit 3 through off-system sales in the economy energy market. For several years, market prices for economy energy sales have not been at levels sufficient to recover the New Mexico portion of the Company's current operating expenses related to Unit 3, including decommissioning costs and lease payments. The Company expects these market prices to remain at such levels in the near term. The Company projects, however, that the market prices of economy energy ultimately will rise to a level sufficient to recover the New Mexico jurisdictional portion of the Company's investment in Unit 3 over the remaining life of the asset.

Performance Standards for Palo Verde. In 1986, the New Mexico Commission established performance standards in Case 1833 for the operation of the Palo Verde units. The entire station is evaluated annually to determine if its achieved capacity factor entitles the Company to a reward or a penalty. There are five performance bands based around a target capacity factor of 67.5%. Neither a penalty nor a reward would result from capacity factors from 60% to 75%. The capacity factor is calculated as the ratio of actual generation to maximum possible generation. Since Unit 3 is not in rate base for purposes of New Mexico rates, any penalty or reward calculated on a total station basis is limited to two-thirds of such penalty or reward. If the annual capacity factor is 35% or less, the New Mexico Commission is required to initiate a proceeding to reconsider the rate base treatment.

Annual Filing Requirements. Pursuant to the New Mexico Commission's order in Case 1833, the Company must make annual filings, at least through the term of the rate moderation plan, to reconcile fuel costs and establish the fixed fuel factor for New Mexico customers. An annual performance

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NOTES TO FINANCIAL STATEMENTS - (Continued)

standards report is included in the fuel reconciliation and any resulting rewards or penalties are included in the establishment of a new fixed fuel factor, if a new factor is warranted. The Company has received an extension through March 31, 1994 to file its annual fuel reconciliation report for the period January 1, 1993 through December 31, 1993. The Company expects such report will result in a significantly higher fuel factor, including no reward or penalty under the performance standards. The new factor is proposed to be implemented in May 1994. The Company also has requested an extension to file a cost of service compliance report with the New Mexico Commission in June 1994.

Federal Energy Regulatory Commission Rate Matters

The majority of the Company's rates for wholesale power and transmission services are subject to regulation by the FERC. Sales of wholesale power subject to FERC regulation make up a significant portion, approximately 15% in 1993, of the Company's operating revenues. Although rates to wholesale customers require FERC approval, the Company and its wholesale customers generally have established such rates through negotiations, based on certain cost of service assumptions, subject to FERC acceptance of the negotiated rates.

The Company has a long-term firm power sales agreement with Imperial Irrigation District ("IID") providing for the sale of 100 MW of firm capacity to IID through April 2002. The Company also provides contingent capacity of 50 MW to IID. The agreement generally provides for level sales prices over the life of the agreement, which were intended to recover fully the Company's projected costs, as well as a return. Because of the levelized rate, such costs and return were anticipated to exceed revenues for a number of the early years of the agreement with a reciprocal effect in the later years of the agreement. The Company has accrued revenues under the terms of the agreement in the amounts of \$2.4 million, \$2.9 million, and \$4.9 million in 1993, 1992 and 1991, respectively. Such accrued amounts, which since the inception of the agreement aggregate \$32 million as of December 31, 1993, are recorded as a long-term contract receivable on the Company's balance sheets. Based on the contractual payments, recovery of the unbilled amounts should begin in 1995. The agreement also provides that the Company may seek increases in the sales price if sufficient evidence exists to determine that certain operating costs have increased above those used in determining the original sales price.

The Company has a firm power sales agreement with Texas-New Mexico Power Company ("TNP"), providing for sales to TNP in the amount of 79 MW in 1993 and 75 MW thereafter through 2002, subject to provisions in the agreement that allow a reduction to a minimum of 25 MW in the amount of demand on a yearly basis. TNP has provided the Company notice that it would take advantage of the provisions to reduce the contract demand to 25 MW for 1994 and 1995, while preserving its option to maintain or reduce its contract demand in subsequent years. Sales prices, which decline over the life of the agreement, are based on substantially the same scheduled and projected costs and return as the IID agreement discussed above.

Rate tariffs currently applicable to IID and TNP contain appropriate fuel and purchased power cost adjustment provisions designed to recover the Company's fuel and purchased power costs.

Other Wholesale Customers

The Company has a sales agreement to provide capacity and associated energy to CFE through the end of 1996. The sales will be at 150 MW during the summer months and 120 MW at other times of the year through the remaining term of the agreement. Pricing for the agreement includes an escalating capacity charge and recovery of energy costs at system-average costs plus third-party energy charges. To support the requirements of the agreement with CFE, the Company entered into a firm power purchase agreement with SPS for at least 50 MW during the term of the CFE contract.

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NOTES TO FINANCIAL STATEMENTS - (Continued)

D. Summary of Significant Accounting Policies

General. The Company maintains its accounts in accordance with the Uniform System of Accounts prescribed for electric utilities by the FERC. The Company, prior to December 31, 1991, reported its regulated utility operations pursuant to SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," as amended. As more fully discussed in Note C, the Company discontinued the application of SFAS No. 71 as of December 31, 1991 and accounted for such discontinuation in accordance with SFAS No. 101, "Regulated Enterprises — Accounting for the Discontinuation of Application of SFAS No. 71."

The Company has accounted for all transactions related to the reorganization proceedings in accordance with Statement of Position 90-7, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code" ("SOP 90-7"), issued by the American Institute of Certified Public Accountants in November 1990. Accordingly, all prepetition liabilities of the Company that are expected to be impaired under the plan of reorganization are reported separately in the Company's balance sheet as obligations subject to compromise (See Note H for a description of such obligations). Expenses and interest income resulting directly from the reorganization proceedings are reported separately in the Statements of Operations as reorganization items.

The confirmation of the Plan (Note A) did not result in changes in the carrying amounts of the Company's assets or liabilities or the accounting bases used by the Company. Changes caused by emerging from bankruptcy would be reflected at the Effective Date. In addition, the effects of the Merger have not been reflected because of uncertainties regarding whether the Merger will be consummated. In the event the Merger is consummated, it is anticipated that it would be recorded using the purchase method of accounting whereby the Company's assets and liabilities would be adjusted to market value on the Effective Date.

Utility Plant. Utility plant is stated at original cost, less regulatory disallowances. Costs include labor, material, construction overheads, an allowance for funds used during construction ("AFUDC") and capitalized interest effective January 1, 1992 (see AFUDC discussion below). 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 which range from 12 years to 49 years. Palo Verde Station is being amortized on a straight-line basis over approximately 40 years.

The Company charges the cost of repairs and minor replacements to the appropriate operating expense accounts and capitalizes the cost of renewals and betterments. Gains or losses resulting from retirements or other dispositions of operating property in the normal course of business are credited or charged to the accumulated provision for depreciation.

Decommissioning cost for the Company's interest in Palo Verde is charged to depreciation expense. The Company amortizes decommissioning costs over the estimated service life for the portion of its owned interest and over the term of the related leases for the portions sold and leased back.

The cost of nuclear fuel is amortized to fuel expense on a unit-of-production basis. A provision for spent fuel disposal costs is charged to expense based on requirements of DOE for disposal cost of one-tenth of one cent on each kilowatt hour generated.

AFUDC. As a result of discontinuation of the application of SFAS No. 71, the Company discontinued accruing AFUDC in 1992. In place of AFUDC, the Company capitalizes to construction work in progress ("CWIP") interest cost calculated in accordance with SFAS No. 34, "Capitalization of

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"Interest Cost," and SOP 90-7. The amount of AFUDC was 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 for AFUDC was 8.35% for 1991.

Cash and Cash Equivalents. All temporary cash investments with an original maturity of three months or less are considered cash equivalents.

Investments. The Company values its investments at amortized cost. Such investments consist primarily of municipal bonds in trust funds established for decommissioning Palo Verde. SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," will require these investments to be valued at market value beginning in 1994. The Company does not believe the effects of adopting SFAS No. 115 will be significant.

Inventories. Inventories, primarily parts, materials and supplies, are stated at average cost.

Operating Revenues. Operating revenues are accrued for sales of electricity subsequent to monthly billing cycle dates but prior to the end of the accounting month.

Fuel Cost Adjustment Provisions. Fuel revenues and expense are stated at actual cost incurred. 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. 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. Any difference in fuel cost versus cash recovery from the Company's ratepayers is reflected as over/under-recovered fuel in the balance sheet.

Federal Income Taxes and Investment Tax Credits. Effective January 1, 1993, the Company began accounting for federal income taxes under SFAS No. 109, "Accounting for Income Taxes," which requires the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred income taxes are recognized for the estimated future tax consequences of "temporary differences" by applying enacted statutory tax rates for each taxable jurisdiction applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. SFAS No. 109 recognizes the effect on deferred tax assets and liabilities of a change in tax rate in income in the period that includes the enactment date. Prior to 1993, in accordance with Accounting Principles Board Opinion No. 11 ("APB Opinion No. 11"), the Company used the deferred method of accounting for income taxes. Under the deferred method, deferred income taxes are provided on timing differences between reporting income and expense items for financial statement and income tax purposes. The Company recognized the effect of a change in accounting principle for the adoption of SFAS No. 109 by a \$96 million charge to results of operations.

Investment tax credit generated by the Company is deferred and amortized to income over the estimated remaining useful lives of the property that generated the credit.

Benefit Plans. See Note L for accounting policies regarding the Company's retirement plans and postretirement benefits.

Reclassifications. Certain amounts in the financial statements for 1992 have been reclassified to conform with the 1993 presentation.

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NOTES TO FINANCIAL STATEMENTS - (Continued)

E. Palo Verde Nuclear Generating Station

The Company has a 15.8% undivided interest in the Palo Verde Station in which six other utilities (collectively, the "Palo Verde Participants") have interests, including Arizona Public Service Company ("APS"), who is the operating agent of Palo Verde. The operation of Palo Verde and the relationship among the Palo Verde Participants is governed by the ANPP Participation Agreement. A summary of the Company's 15.8% investment in the three 1,270 MW nuclear generating units, which comprise Palo Verde Station and investment in other jointly owned utility plant, excluding fuel, is as follows:

	<u>Electric Plant in Service</u>	<u>Accumulated Depreciation</u> (In thousands)	<u>Construction Work in Progress</u>
December 31, 1993:			
Palo Verde Station	\$ 928,351	\$ (112,296)	\$ 19,881
Other	133,561	(49,628)	1,833
December 31, 1992:			
Palo Verde Station	\$ 916,604	\$ (93,456)	\$ 22,397
Other	133,301	(44,623)	995

The Company's investment, at cost, in the Palo Verde Station in the amount of approximately \$948.2 million at December 31, 1993 excluded amounts of approximately \$653.4 million 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 B of Notes to Financial Statements for information regarding such transactions and the Company's lease obligations relating thereto. The Company's share of direct expenses of operating jointly owned plant is included in the corresponding operating expense captions on the statement of operations.

Steam Generator Tubes. Following the rupture of a steam generator tube in Unit 2 on March 14, 1993, APS began an inspection program of the steam generators in each unit. Such program included inspections of tubes in both steam generators in each unit, beginning with Unit 2 during its scheduled refueling outage that began in March 1993, and continuing with the regularly scheduled refueling outage for Unit 1 in September 1993 and mid-cycle inspection outages for Unit 3 in November 1993 and Unit 2 in January 1994.

APS identified and implemented corrective actions to address the accelerated tube degradation found in Unit 2 and the more common type of tube cracking found in each unit during the inspections. Such corrective actions include chemical cleaning, operating at reduced temperature levels and, for a period of time, operating each unit at 85-86% power.

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 rating program for each nuclear incident is approximately \$79.2 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 \$37.6 million, with an annual payment limitation of approximately \$4.7 million.

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NOTES TO FINANCIAL STATEMENTS - (Continued)

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 \$2.7 billion, a substantial portion of which must first be applied to stabilization and 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.

Decommissioning. The Company's depreciation expense includes approximately \$7.5 million, \$5.2 million and \$3.6 million in 1993, 1992 and 1991, respectively, for the estimated future decommissioning costs for the owned and leased portions of Palo Verde based on decommissioning studies performed for the Company. The above amounts reflect updated studies implemented in July 1992 and September 1993. The Company is accruing its decommissioning obligation 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 portions of Palo Verde that were sold and leased back. As of December 31, 1993, the Company has accrued approximately \$30.1 million of decommissioning costs, including interest, which is reflected in the Company's balance sheet in deferred credits and other liabilities.

The Company is utilizing a site specific study for Palo Verde, dated December 1993, prepared for the Company by an independent consultant, that estimates the cost to decommission the Company's share of Palo Verde to be approximately \$221 million (stated in 1993 dollars). Such amount includes an estimated cost to decommission on-site spent fuel storage facilities of approximately \$50 million. The study assumes the prompt removal/dismantlement method of decommissioning will be used to decommission Palo Verde. The study also assumes (i) that decommissioning will take place from 2024 through 2035 for the production units, (ii) that maintenance expense for spent fuel storage will be incurred from 2035 through 2067 and (iii) that decommissioning of the spent fuel storage facilities will occur in 2067. Although the study is based on the latest available information, there can be no assurance that decommissioning costs will not continue to increase in the future.

The Company has established trusts with independent trustees, which enable the Company to record a current deduction for federal income tax purposes of a portion of amounts funded. As of December 31, 1993, the aggregate balance of the trust funds was approximately \$15.8 million, which is reflected in the Company's balance sheet in deferred charges and other assets. Earnings on the trusts' funds of approximately \$600,000, \$500,000 and \$400,000 in 1993, 1992 and 1991, respectively, are reflected on the statements of operations as interest income. The Company is currently collecting a portion of decommissioning costs for Palo Verde Units 1 and 2 in all three of its ratemaking jurisdictions and for Unit 3 in its Texas and FERC jurisdictions. The Company must fund the decommissioning requirements for the New Mexico jurisdictional portion of Unit 3 through off-system sales of economy energy as Unit 3 is excluded from New Mexico jurisdictional rate base. Because the Company is under fixed-price long term contracts with its FERC customers, the amount of decommissioning costs received in current rates is insufficient to fund the FERC portion of decommissioning costs, and therefore, the Company must fund this shortfall through internally generated cash.

Currently, the Company is funding decommissioning costs over the estimated service life for its owned portion of Palo Verde and, prior to filing the bankruptcy petition, over the term of the related leases for the leased portion of Palo Verde. Subsequent to the filing of the bankruptcy petition, the Company has made contributions to the decommissioning trusts pursuant to funding requirements of the NRC, the ANPP Participation Agreement and orders of the Texas Commission, the New Mexico Commission and the FERC. These funded amounts are slightly less than what would have been required pursuant to provisions under applicable agreements related to the Company's sale/leaseback

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NOTES TO FINANCIAL STATEMENTS - (Continued)

transactions for Units 2 and 3. Under the proposed terms of the Plan, the Company would reacquire all portions of Palo Verde sold and leased back. If this occurs, the Company anticipates it would accrue for and fund all portions of the Palo Verde decommissioning costs over the operating license terms. This funding method has been incorporated in the rate request in the Company's rate filing currently pending before the Texas Commission.

The Energy Policy Act includes an assessment for decontamination of the DOE's enrichment facilities. The total amount of this assessment has not yet been finalized; however, based on preliminary indications, APS estimates that the annual assessment for Palo Verde will be approximately \$3 million, plus increases for inflation, for the next fifteen years. The Company recorded a charge to results of operations in 1992 in the amount of approximately \$7.1 million which represents its portion of the estimated assessment.

The SEC staff recently announced its intention to require that estimated total decommissioning costs be recorded as a liability in the financial statements beginning in 1994. The FASB indicated that it may consider the broader area of the treatment of environmental exit costs, which would encompass decommissioning of nuclear power plants. The SEC staff has preliminarily indicated that if the FASB considers this issue, it will delay any change in the current practice of accruing the decommissioning liability over the plant's useful life, pending FASB action. If the SEC staff were to require such a change in 1994, the Company would be required to record an additional liability of approximately \$191 million based on the current cost estimates discussed above. At the present time, the Company cannot predict the effects on the financial condition or results of operations if it were required to record the additional liability.

ANPP Participation Agreement. Pursuant to the ANPP Participation Agreement, each Palo Verde Participant is required to fund its proportionate share of operation and maintenance, capital and fuel costs of Palo Verde. The Company's total monthly share of these costs is approximately \$7 million. The ANPP Participation Agreement provides that if a Palo Verde Participant fails to meet its payment obligations, each non-defaulting Palo Verde Participant shall pay its proportionate share of the payments owed by the defaulting Palo Verde Participant. On February 13, 1992, the Bankruptcy Court approved a stipulation between the Company and APS, as the operating agent of Palo Verde, pursuant to which the Company agreed to pay its proportionate share of all Palo Verde invoices delivered to the Company after February 6, 1992. The Company agreed to make these payments until such time as an order is entered by the Bankruptcy Court, if ever, authorizing or directing the Company's rejection of the ANPP Participation Agreement governing the relationship among the Palo Verde Participants. The stipulation also specifies that approximately \$9.2 million of the Company's Palo Verde payment obligations are to be considered prepetition general unsecured claims of the other Palo Verde Participants. Pursuant to the Plan, the Company intends to assume the ANPP Participation Agreement and the other agreements related to the operation of Palo Verde. To accomplish this and to resolve pending issues related to the assumption of the agreements and cure of existing defaults, the Company and the other Palo Verde Participants have entered into a Cure and Assumption Agreement that was approved by the Bankruptcy Court on November 19, 1993. The Cure and Assumption Agreement sets forth the mechanism by which the ANPP Participation Agreement and other operating agreements related to Palo Verde will be assumed as of the Effective Date. Pursuant to the agreement, the Company paid APS, as operating agent, the amount of the prepetition obligations and APS paid the Company amounts of prepetition refunds that had been withheld, subject to all of such amounts being returned in the event the Plan does not become effective.

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F. Common Stock

In May 1989, the Board of Directors eliminated the second quarter 1989 common stock dividend and the Company has not paid dividends on its common stock since then.

Resumption of dividends on common stock will depend on the terms of the Plan that becomes effective in the Company's Bankruptcy Case as well as applicable provisions of state law and the Federal Power Act. Under certain provisions of the Federal Power Act regarding the payment of dividends on capital stock, as interpreted by the staff of the FERC, the Company is permitted to pay dividends on its capital stock only out of retained earnings.

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 open 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. Discount from fair market value is charged to expense. This employee benefit plan will terminate June 30, 1994.

Employee Stock Compensation Plan. The Company has a broad-based employee stock compensation plan under which shares of Company common stock may be 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. In 1991, the Board of Directors approved the reservation of an additional 600,000 shares of stock for issuance under the plan. However, the Company has not filed the necessary applications with the New Mexico Commission and the FERC to obtain approval of the issuance of the additional 600,000 shares or the registration statement related to such shares with the SEC and does not intend to do so at the current time. Market value of shares issued would be charged to expense. Under the Plan and Merger, this employee benefit plan would be terminated at the Effective Date of the Plan.

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.

At December 31, 1993, the outstanding common stock options are as follows:

<u>Date of Options</u>	<u>Option Price</u>	<u>Number of Shares</u>
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	895,525
May 18, 1992	3.000	750,000
November 17, 1992	2.500	722,100
Total options outstanding		<u>2,989,025</u>
Total options exercisable at December 31, 1993		<u>1,516,925</u>

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Subsequent to December 31, 1993, options representing 834,394 shares of the Company's common stock expired. Options for a total of 840,394 shares are available for award under the stock option plan.

Options granted November 19, 1990, May 18, 1992 and November 17, 1992 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. In addition, the options granted May 18, 1992 and November 17, 1992 are not exercisable with certain exceptions, until a plan of reorganization becomes effective in the Company's Bankruptcy Case. All other options granted were exercisable immediately. All 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 in control of the Company, as defined in the plan. Options are granted at the discretion of the Compensation/Benefits Committee of the Board. During 1993 and 1992 there were no options exercised. Under the Plan and pursuant to the Merger Agreement, options outstanding at the Effective Date of the Plan would be converted to options to purchase common stock of CSW.

Changes in common stock are as follows:

	Common Stock	
	Shares	Amount (In thousands)
Balance December 31, 1990	35,352,211	\$ 338,302
Issuances of Common Stock:		
1991	173,250	745
1992	9,502	31
1993	9,367	19
Balance December 31, 1993	<u>35,544,330</u>	<u>\$ 339,097</u>

Shares of common stock reserved for issuance under the above described stock benefit plans were 3,116,680 at December 31, 1993.

Directors' Stock Compensation Plan. In 1991, the Board of Directors approved a Directors' Stock Compensation Plan, which was submitted to and approved by the shareholders of the Company at the Annual Meeting held May 20, 1991, subject to regulatory approval. However, the Company has not filed the necessary applications with the New Mexico Commission and the FERC to obtain approval of the issuance of up to 300,000 shares of common stock under the plan or filed a registration statement related to the shares to be issued under the plan with the SEC and does not intend to do so at the current time. A total of 300,000 shares of the Company's common stock would be reserved for issuance under the plan if the regulatory approvals are obtained. Issuances at fair market value would be charged to expense. Under the Plan and the Merger, this benefit plan would be terminated at the Effective Date of the Plan.

G. Preferred Stock

The Board of Directors voted to suspend, effective for the October 1, 1991 scheduled payment date, payment of preferred stock dividends, as well as sinking fund payments on the preferred stock. The Company cannot predict when the preferred stock dividends and sinking fund payments will be resumed, if ever, but such payments are precluded by the Bankruptcy Code during the Company's Bankruptcy Case. (See Note A for the treatment of preferred stock, including interim payments, under the Plan.)

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Since dividends on the outstanding preferred stock have accumulated and remained unpaid in a cumulative amount at least equal to four quarterly dividends, pursuant to provisions of the Company's articles of incorporation and applicable stock purchase agreements, the holders of the preferred stock have been entitled (subject to satisfaction of certain procedural requirements) to elect two additional directors to the Board of Directors since July 1, 1992 and will have such right until all dividends on preferred stock have been fully paid or until dividends on any of the outstanding preferred stock accumulate and remain unpaid in an amount equal to twelve full quarterly dividends. Under the Company's articles of incorporation, if preferred stock dividends in an amount equal to twelve full quarterly dividends are unpaid, the holders of the preferred stock would be entitled to elect the smallest number of directors necessary to constitute a majority of the full Board of Directors until all dividends on preferred stock have been fully paid. When the right to elect directors accrues to the holders of preferred stock, such holders vote as a class. Under the Plan, by voting in favor of the Plan, the preferred shareholders have waived any right to elect a majority of the Board of Directors under the Company's articles of incorporation. The Company has not received notice of any preferred shareholder's desire or intent to exercise the right to elect two additional directors and cannot predict whether or when any such action might be taken.

As discussed earlier, the Company suspended payment of dividends on all series of the Company's preferred stock effective for the October 1, 1991 scheduled payment date. The Company accrued dividends on and increased the balance of preferred stock, redemption required, with an offsetting decrease to retained earnings for the last two quarters of 1991. No such dividends have been accrued on preferred stock, redemption not required. However, since dividends on all series of the Company's preferred stock are cumulative, net loss applicable to common stock and net loss per weighted average shares of common stock outstanding have been computed through December 31, 1991 assuming that all such dividends were accrued.

Because of the bankruptcy filing, the Company, beginning with the first quarter of 1992, ceased accruing any dividends on preferred stock and eliminated the deduction of preferred stock dividend requirements from the determination of net income (loss) applicable to common stock and net income (loss) per weighted average shares of common stock outstanding insofar as the preferred stock is subordinate to unsecured obligations.

Following is a summary of cumulative per share dividends in arrears and cumulative dividends in arrears of issued and outstanding preferred stock, as of December 31, 1993, calculated according to the terms of the preferred stock:

		<u>Cumulative Per Share Dividends in Arrears</u>	<u>Cumulative Dividends In Arrears (In thousands)</u>
Preferred Stock, Redemption Required:			
\$ 10.75	Dividend	\$ 26.88	\$ 1,398
\$ 8.44	Dividend	21.10	2,059
\$ 8.95	Dividend	22.38	2,014
\$10.125	Dividend	25.31	2,531
\$11.375	Dividend	28.44	8,531
			<u>\$ 16,533</u>
Preferred Stock, Redemption not Required:			
\$ 4.50	Dividend	\$ 11.25	\$ 169
\$ 4.12	Dividend	10.30	155
\$ 4.72	Dividend	11.80	236
\$ 4.56	Dividend	11.40	456
\$ 8.24	Dividend	20.60	1,080
			<u>\$ 2,096</u>

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The aggregate amount of accumulated and unpaid preferred stock dividends as of December 31, 1993 is approximately \$18.6 million (preferred stock, redemption required, approximately \$16.5 million, of which approximately \$3.3 million has been accrued; preferred stock, redemption not required, approximately \$2.1 million).

Preferred Stock, Redemption Required. Following is a summary of issued and outstanding preferred stock, redemption required:

	<u>Shares</u>	<u>Amount</u> (In thousands)	Optional Redemption Price Per Share at December 31, 1993
\$ 10.75 Dividend	52,000	\$ 5,200	\$ 102.50
\$ 8.44 Dividend	97,600	9,760	102.11
\$ 8.95 Dividend	90,000	9,000	104.48
\$ 10.125 Dividend	100,000	10,000	100.00
\$ 11.375 Dividend	<u>300,000</u>	<u>30,000</u>	100.00
	<u>639,600</u>	<u>63,960</u>	
Accrued dividends in arrears		<u>3,306</u>	
		<u><u>\$ 67,266</u></u>	

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). Sinking fund payments in the following amounts have been missed: (i) \$750,000 (7,500 shares at \$100 per share) due each of October 1, 1991, October 1, 1992 and October 1, 1993 on the Company's \$8.95 Dividend Preferred Stock; (ii) \$600,000 (6,000 shares at \$100 per share) due each of October 1, 1991, October 1, 1992 and October 1, 1993 on the Company's \$8.44 Dividend Preferred Stock; (iii) \$400,000 (4,000 shares at \$100 per share) due each of January 1, 1992, January 1, 1993 and January 1, 1994 on the Company's \$10.75 Dividend Preferred Stock; (iv) \$10 million (100,000 shares at \$100 per share) due each of July 1, 1992 and July 1, 1993 on the Company's \$11.375 Dividend Preferred Stock and (v) \$5 million (50,000 shares at \$100 per share) due each of July 1, 1992 and July 1, 1993 on the Company's \$10.125 Dividend Preferred Stock. At December 31, 1993 the total arrearage of mandatory sinking fund payments is \$34.9 million.

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NOTES TO FINANCIAL STATEMENTS - (Continued)

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

1994	\$ 11,750
1995	1,750
1996	1,750
1997	1,750
1998	1,750

Redemptions of preferred stock, redemption required were as follows:

	<u>Shares</u>	<u>Amount</u>
		(In thousands)
Balance at December 31, 1990	793,600	\$ 79,360
Redemption of Preferred Stock, \$10.75 Dividend	(4,000)	(400)
Redemption of Preferred Stock, \$10.125 Dividend	(50,000)	(5,000)
Redemption of Preferred Stock, \$11.375 Dividend	(100,000)	(10,000)
Cumulative dividends in arrears	—	3,306
Balance at December 31, 1991, 1992 and 1993	639,600	\$ 67,266

Preferred Stock, Redemption not Required. Following is a summary of preferred stock issued and outstanding at December 31, 1993 which is not redeemable except at the option of the Company:

	<u>Shares</u>	<u>Amount</u>	<u>Optional Redemption Price Per Share</u>
		(In thousands)	
\$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	101.34
	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.

H. Obligations Subject to Compromise

Under the Bankruptcy Code, certain claims against the Company in existence prior to the Petition Date for reorganization under the Bankruptcy Code are stayed, subject to their treatment in the Plan (or another plan of reorganization that becomes effective). Additional claims which may also be subject to compromise, have arisen and may continue to arise subsequent to the Petition Date as a result of rejection of executory contracts, including the Palo Verde Leases and other leases, and from the determination by the Bankruptcy Court (or as may be agreed to by parties in interest) of allowed claims for contingencies and other disputed amounts. In accordance with the SOP 90-7, these claims are reflected, at amounts expected to be allowed by the Bankruptcy Court, in the December 31, 1993 and 1992 balance sheets as "Obligations Subject to Compromise," which amounts could differ substantially from the settled amounts. For a description of the treatment of claims under the Plan, see Note A.

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

The expiration date for filing creditors' claims against the Company with the Bankruptcy Court was June 15, 1992. Approximately 500 proofs of claim had been filed with the Bankruptcy Court and as of December 31, 1993, unresolved claims approximate \$5.4 billion. There also are approximately 70 proofs of claims that do not specify an amount. The Company continues the process of reviewing each proof of claim to reconcile the claimed amount with the Company's books and records and believes the outstanding claimed amounts are grossly overstated. The Company's estimates of the allowed claims as presented in the financial statements are therefore subject to change based upon the outcome of the Chapter 11 proceedings.

In late December 1991, the Company ceased paying principal, interest and fees on portions of its secured and unsecured debt except as described below. All of the Company's debt is in default as a result of the events leading to the bankruptcy filing or the filing itself, as discussed below. The Company expects to remain in default under its existing financing arrangements until a plan of reorganization becomes effective pursuant to the Bankruptcy Case. These defaults generally would entitle the Company's creditors to accelerate the outstanding principal amounts of debt and pursue other remedies available under the applicable agreements. As a result of the automatic stay imposed by the provisions of the Bankruptcy Code, however, such creditors generally are prevented from taking any action to collect such amounts or pursue any remedies against the Company other than through the Bankruptcy Case. The terms and provisions of the Company's financing arrangements, including the maturity dates, would be modified if the Plan becomes effective.

In accordance with SOP 90-7, through the Confirmation Date, the Company has been accruing interest, at contractual non-default rates, only on debt secured by first or second mortgages to the extent that the value of underlying collateral exceeds the principal amount of First and Second Mortgage Bonds and no interest was accrued on other debt. As described in Note A the Plan requires the Company to make interim payments representing interest on other debt and such amounts have been recorded since the Confirmation Date.

Since the filing of the petition for reorganization, the Bankruptcy Court has issued various orders authorizing payment of interest accruing since July 1, 1992 to certain secured creditors. The Company paid approximately \$64.7 million and \$32.5 million for 1993 and 1992, respectively in interest on First and Second Mortgage Bonds of the Company for the period of July 1, 1992 through December 31, 1993, including those bonds held as security for the Company's revolving credit facility, described below, and interest on three series of pollution control bonds. With respect to three series of pollution control bonds, the Company has reserved its right to repayment from the banks issuing letters of credit supporting such bonds of amounts paid to reimburse the banks for interest paid on the bonds through draws on the letters of credit in the event that the Bankruptcy Court determines the payments to the banks were payments of unsecured claims. The Plan does not contemplate seeking such a ruling, however. The contractual obligations of the Company's debt agreements require principal payments to be made during the next year of approximately \$29.9 million; these amounts are presented as non-current because of the stay as of the Petition Date. Contractual obligations of the Company's debt agreements required principal payments in 1993 and 1992 of approximately \$26.1 million and \$69.7 million, respectively, of which approximately \$900,000 and \$800,000 were paid during the same respective periods. Contract non-default interest on unsecured and undersecured debt was approximately \$40.9 million and \$41.1 million in 1993 and 1992, respectively, which has not been accrued by the Company. As explained in Note A above, interim payments of approximately \$10.2 million were accrued in 1993 and recorded as interest expense.

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NOTES TO FINANCIAL STATEMENTS - (Continued)

The following is a summary of obligations subject to compromise:

	<u>December 31,</u>	
	<u>1993</u>	<u>1992</u>
<u>Secured Debt:</u>		
First Mortgage Bonds (1):		(In thousands)
4 5/8% Series, issued 1962, due 1992	\$ 10,385	\$ 10,385
6 3/4% Series, issued 1968, due 1998	24,800	24,800
7 3/4% Series, issued 1971, due 2001	15,838	15,838
9% Series, issued 1974, due 2004	20,000	20,000
10 1/2% Series, issued 1975, due 2005	15,000	15,000
8 1/2% Series, issued 1977, due 2007	25,000	25,000
9.95% Series, issued 1979, due 2004	17,559	17,559
13 1/4% Series, issued 1984, due 1994	17,700	17,700
11.10% Series, issued 1990, due 2001	<u>153,000</u>	<u>153,000</u>
	<u>299,282</u>	<u>299,282</u>
Second Mortgage Bonds (2):		
11.58% Series, issued 1990, due 1997	35,000	35,000
12.63% Series, issued 1990, due 2005	105,000	105,000
12.02% Series, issued 1991, due 1999	<u>25,000</u>	<u>25,000</u>
	<u>165,000</u>	<u>165,000</u>
Revolving credit facility secured by First and Second Mortgage Bonds, due 1992 (3)	<u>150,000</u>	<u>150,000</u>
Pollution Control Bonds (4):		
Secured by Second Mortgage Bonds:		
Variable rate bonds, due 2014, net of \$1,740,000 and \$1,703,000, respectively, on deposit with trustee	61,760	61,797
Variable rate refunding bonds, due 2014	37,100	37,100
Variable rate refunding bonds, due 2015	<u>59,235</u>	<u>59,235</u>
	<u>158,095</u>	<u>158,132</u>
Nuclear fuel financing (5)	60,620	60,620
Accrued interest (6)	45,654	45,308
Other	<u>14,654</u>	<u>15,348</u>
Total secured debt	<u>893,305</u>	<u>893,690</u>
<u>Unsecured Debt:</u>		
Notes payable to banks (7)	288,416	288,416
Pollution control bonds, variable rate, refunding bonds, due 2013, net of \$4,041,000 and \$3,957,000, respectively on deposit with trustee (4)	31,764	31,848
Promissory note due 1992 (8)	25,000	25,000
Financing obligation Palo Verde Unit 2 (9)	79,186	79,186
Accrued operating lease cost, Palo Verde Units 2 and 3 (Note B)	137,734	70,473
Capitalized lease obligation, Copper Turbine (10)	9,061	9,928
Prepetition accrued interest	4,837	4,837
Other	<u>26,012</u>	<u>37,590</u>
Total unsecured debt	<u>602,010</u>	<u>547,278</u>
	<u>\$ 1,495,315</u>	<u>\$ 1,440,968</u>

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

(1) First Mortgage Bonds

The First Mortgage Indenture is secured by substantially all of the Company's utility plant. Under the First Mortgage Indenture the Company may issue bonds to the extent of 60% of the value of unfunded (as defined in the Indenture) net additions to the Company's utility property, provided that earnings available for interest are at least equal to twice the annual interest requirements on all bonds to be outstanding and on all prior lien debt.

The First Mortgage Indenture provides for sinking and improvement funds, except as otherwise noted, equivalent to 1%, (approximately \$1 million at December 31, 1993), 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 the bonds or by purchasing bonds in the open market. However, this requirement was not met in 1992 or 1993. With respect to the 9.95% series, the agreement provides for 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, approximately \$1.1 million as of December 31, 1993. With respect to the 13.25% series, the agreement provides for 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, \$5.9 million as of December 31, 1993. With respect to 11.10% series, commencing in June and December 1995, the agreement provides for 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 following amounts are contractually due as follows: 1992 - \$18.4 million; 1993 - \$8 million; 1994 - \$8 million; 1995 - \$23.9 million; 1996 - \$23.9 million; 1997 - \$23.9 million; 1998 - \$47 million.

(2) Second Mortgage Bonds

The Second Mortgage Indenture is secured by substantially all of the Company's utility plant. Under the Second Mortgage Indenture the Company may issue bonds on the basis of 40% of the value of unfunded (as defined in the Indenture) net additions to the Company's utility property, or to the extent of the principal amount of retired bonds.

The Second Mortgage Indenture provides for sinking funds. With respect to the 11.58% series, the agreement provides for annual cash payments to the trustee commencing in December 1994, equivalent to 25% of the greatest aggregate principal amount of such series outstanding at any one time prior to a specified date. With respect to the 12.63% series, the agreement provides for annual cash payments to the trustee commencing in December 2001, of a specified amount. The following approximate amounts are contractually due as follows: 1994 - \$8.8 million; 1995 - \$8.8 million; 1996 - \$8.8 million; 1997 - \$8.8 million.

(3) Revolving Credit Facility

The Company currently has a total of \$150 million of debt outstanding under a revolving credit facility (the "RCF"). The RCF, which involves a syndicate of money center banks, provided for substantially all of the Company's short-term borrowing prior to the filing of the bankruptcy petition. The RCF became due and payable on January 9, 1992. The RCF is secured by \$50 million of First Mortgage Bonds and \$100 million of Second Mortgage Bonds. Interest on the

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

RCF is calculated at the non-default contract rate at the administrating bank's current quoted prime rate plus 1%. Interest rate at December 31, 1993 was 7%.

(4) Pollution Control Bonds

The Company has approximately \$195.6 million of tax exempt Pollution Control Bonds outstanding consisting of four issues, of which three issues aggregating \$159.8 million are secured by a second mortgage. The bonds bear interest at various rates (1.54% to 3.825% during 1993) which will cause the bonds to have a market value which approximates, as nearly as possible, their par value. Each of the tax exempt issues is credit enhanced by a letter of credit. Prior to the Petition Date, interest and other payments on the Pollution Control Bonds were made through draws on the letters of credit, and the Company reimbursed the letter of credit banks for such draws. Subsequent to the petition filing, interest on all the bonds has continued to be paid by draws on the letters of credit. The Company has paid a portion of the resulting reimbursement obligations to the issuing banks on three Pollution Control Bond issues through the interest payments authorized by the Bankruptcy Court.

In May 1992, one series of the secured Pollution Control Bonds was accelerated and the letter of credit supporting such series was drawn upon for the principal and accrued interest. The Company has not reimbursed the letter of credit bank for the drawing, which aggregated approximately \$37.9 million. The Company has been informed that the letter of credit issuer for the accelerated bonds asserts that the accelerated bonds, which remain outstanding, are held as collateral to secure the reimbursement obligations of the Company to the letter of credit issuer. No court determination has been made as to the validity or enforceability of the collateral interest asserted by such letter of credit issuer.

With respect to another series of Pollution Control Bonds, the letter of credit issuer has informed the Company that such letter of credit issuer has purchased all of the outstanding bonds of that series. A third series of Pollution Control Bonds were remarketed during June 1993 and currently remains outstanding. The final series of Pollution Control Bonds was remarketed in November 1993 and remains outstanding. Because of the pendency of the Company's bankruptcy petition as well as other defaults, including the failure of the Company to reimburse the letter of credit issuing banks as described above, the three series of bonds that have not been accelerated are subject to acceleration at any time. In the event that these bonds are accelerated and redeemed, the tax-advantaged interest rate of the bonds may no longer be available to the Company.

(5) Nuclear Fuel Financing

The Company entered into a nuclear fuel purchase contract with a third party grantor trust, Rio Grande Resources Trust ("RGRT"), established for the sole purpose of financing the purchase and enrichment of nuclear fuel for use by the Company at Palo Verde. The aggregate investment of RGRT is reflected on the Company's books at December 31, 1993. Prior to the filing of the Company's bankruptcy petition, the trust generally financed nuclear fuel and all costs in connection with the acquisition of the Company's share of nuclear fuel for use at Palo Verde up to \$125 million pursuant to a borrowing facility (contractual interest rate of 6.72% at December 31, 1993) that is supported by a letter of credit facility. The Company had the option of either paying for the fuel from the trust at the time the fuel was loaded into the reactor or paying for the fuel at the time heat was generated by the fuel. Prior to the petition date of the Bankruptcy Case, the Company elected to pay for the fuel as the heat was produced from the fuel; however, no principal payments of any kind are currently being made to the trust because of the Company's Bankruptcy Case. Since the Company filed its bankruptcy petition,

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(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)
NOTES TO FINANCIAL STATEMENTS - (Continued)

the Company has not sought to finance its fuel costs from the trust, but has instead paid for nuclear fuel with its own funds. The trust contends that it has an enforceable property interest in Palo Verde nuclear fuel, power, energy and revenues, which the Company is disputing in the Bankruptcy Case. The trust and the Company have entered into an interim adequate protection order in the Bankruptcy Case, which essentially preserves the rights, positions and arguments of each party, but does not resolve disputes as to the trust's claims and interests in property.

(6) Accrued Interest

The amount of accrued interest includes approximately \$11.3 million of prepetition interest. The remaining amount represents unpaid postpetition interest, primarily from January 9, 1992 through June 30, 1992.

(7) Notes Payable to Banks

The amount represents the aggregate amount of draws on letters of credit supporting the sales and leasebacks of Palo Verde Units 2 and 3. See discussion of letters of credit draws at Note B.

(8) Promissory Note

The unsecured note due 1992 is floating rate, 6.00% at December 31, 1993.

(9) Financing Obligation, Palo Verde Unit 2

In December 1986, the Company entered into a financing obligation related to one sale and leaseback transaction involving Palo Verde Unit 2 (see Note B). Semiannual payments including interest (using an assumed interest rate of 9.01%), which began in July 1987, are approximately \$4.2 million, with the last payment of approximately \$2.1 million due in July 2013.

(10) Capitalized Lease Obligation, Copper Turbine

In 1980 the Company sold and leased back 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, were approximately \$700,000 through January 1991, and approximately \$900,000 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 approximately \$2.3 million is being amortized to income over the term of the lease. The Company has paid and currently intends to continue to pay all postpetition lease payments on the Copper Lease.

Future contractual minimum annual principal requirements on secured and unsecured debt at December 31, 1993 are as follows (In thousands):

1994	\$ 29,941
1995	38,830
1996	36,481
1997	36,121
1998	50,508

As of December 31, 1993, approximately \$94.1 million remained due on contractual minimum annual principal reduction requirements for 1992 and 1993.

EL PASO ELECTRIC COMPANY
(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)
NOTES TO FINANCIAL STATEMENTS - (Continued)

The table above does not reflect any of the potential effects upon future contractual debt requirements that would result from the Plan becoming effective.

I. Federal Income Taxes

Effective January 1, 1993, the Company adopted SFAS No. 109 and has reported the cumulative effect of that change, approximately \$96 million, separately in the December 31, 1993 Statement of Operations. The charge to operations consists of the recognition of additional tax benefits and valuation allowances as follows:

	<u>Federal</u>	<u>State</u>	<u>Total</u>
	(In thousands)		
Additional net tax benefits	\$ (153,232)	\$ (12,230)	\$ (165,462)
Valuation allowance	<u>219,246</u>	<u>42,260</u>	<u>261,506</u>
Charge to operations	<u>\$ 66,014</u>	<u>\$ 30,030</u>	<u>\$ 96,044</u>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at January 1, 1993, after the adoption of SFAS No. 109, are presented below (In thousands):

Deferred tax assets:

Benefits of tax loss carryforwards	\$ 75,631
Letters of credit draws	98,061
Gain on sale and leaseback transactions	52,400
Accumulated deferred investment tax credits	24,423
Investment tax credit carryforward	28,492
Capital leases	20,598
Alternative minimum tax credit carryforward	548
Other	<u>75,311</u>
Total gross deferred tax assets	375,464
Less valuation allowance (including a valuation for state deferred tax assets of \$42,260,000)	<u>(261,506)</u>
Net deferred tax assets	<u>113,958</u>

Deferred tax liabilities:

Plant, principally due to differences in depreciation and basis	(242,557)
Other	<u>(16,096)</u>
Total gross deferred tax liabilities	<u>(258,653)</u>
Net accumulated deferred income taxes at January 1, 1993	<u>\$ (144,695)</u>

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(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)
NOTES TO FINANCIAL STATEMENTS - (Continued)

As discussed in Note D, the Company's income tax provision was calculated under APB Opinion No. 11 prior to January 1, 1993 and under SFAS No. 109 since that date. The Company recognized income taxes as follows:

	<u>Years Ended December 31,</u>					
	<u>1993</u>	<u>1992</u>	<u>1991</u>			
	(In thousands)					
Income tax expense (benefit):						
Federal:						
Current	\$ 15,253	\$ 31	\$ (2,766)			
Deferred	(20,345)	(1,119)	(100,286)			
Investment tax credit amortization	(2,841)	(2,920)	(3,992)			
Total	<u>\$ (7,933)</u>	<u>\$ (4,008)</u>	<u>\$ (107,044)</u>			
State:						
Current	\$ 3,316	\$ 81	\$ -			
Deferred	(892)	224	367			
Total	<u>\$ 2,424</u>	<u>\$ 305</u>	<u>\$ 367</u>			

The 1993 current federal income expense results from the payment of alternative minimum tax. The 1993 current state income tax expense results from the settlement of Arizona tax claims.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 1993, are presented below (In thousands):

Deferred tax assets:

Benefits of tax loss carryforwards	\$ 33,300
Letters of credit draws	100,946
Gain on sale and leaseback transactions	51,430
Accrued lease expense	53,470
Accumulated deferred investment tax credits	24,147
Investment tax credit carryforward	28,047
Capital leases	24,496
Alternative minimum tax credit carryforward	15,796
Other	<u>68,125</u>
Total gross deferred tax assets	<u>399,757</u>
Less valuation allowance (including a valuation for state deferred tax assets of \$42,318)	<u>(266,215)</u>
Net deferred tax assets	<u><u>133,542</u></u>

Deferred tax liabilities:

Plant, principally due to differences in depreciation and basis differences	(234,783)
Other	(22,694)
Total gross deferred tax liabilities	<u>(257,477)</u>
Net accumulated deferred income taxes at December 31, 1993	<u><u>\$ (123,935)</u></u>

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

The deferred federal income tax benefit in 1993 arises primarily from differences in depreciation methods and lives, deferred and capitalized expenses, accrued lease expense and the recognition of tax benefits related to tax attributes.

The deferred federal income tax benefits from 1992 and 1991 are comprised of the following:

	<u>Years Ended December 31,</u>	
	<u>1992</u>	<u>1991</u>
Depreciation differences	\$ 10,535	\$ 4,222
Deferred and capitalized expenses	(262)	15,881
Sale and leaseback transactions	1,788	2,706
Deferred fuel revenues	(5,244)	(3,359)
Deferred revenues	(142)	2,208
Regulatory disallowance	-	(7,631)
Restructuring costs	-	(3,663)
Loss attributable to letters of credit draws	-	(98,061)
Net tax (benefits) of loss carryforwards	(5,806)	11,420
Other	(1,988)	(1,791)
Extraordinary item, net	-	(22,365)
Total deferred federal income tax benefit	<u>\$ (1,119)</u>	<u>\$ (100,433)</u>

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

Federal income tax provisions differ from amounts computed by applying the statutory rate of 35% in 1993 and 34% in 1992 and 1991 to the book loss before federal income tax as follows:

	<u>Years Ended December 31,</u>		
	<u>1993</u>	<u>1992</u>	<u>1991</u>
	<u>(In thousands)</u>		
Tax benefit computed on loss before extraordinary item at statutory rate	\$ (17,426)	\$ (10,944)	\$ (119,542)
(Decreases) increases due to:			
Amortization of equity funds used during construction	-	1,629	1,557
Investment tax credit amortization (net of deferred taxes in 1993)	(1,846)	(2,920)	(3,992)
Tax benefits of book loss not recognized	-	-	36,994
Non-deductible reorganization costs	11,745	6,889	-
Increase in income tax rate	3,403	-	-
Other	(3,809)	1,338	304
	<u>(7,933)</u>	<u>(4,008)</u>	<u>(84,679)</u>
Tax benefit computed on extraordinary item at statutory rate	-	-	(105,899)
Increases due to:			
Allowance for equity funds used during construction written-off	-	-	6,376
Tax effect of tax-related regulatory assets written-off	-	-	26,917
Tax benefits of book taxable loss not recognized	-	-	44,841
Other	-	-	5,400
	<u>-</u>	<u>-</u>	<u>(22,365)</u>
Total federal income tax benefit	<u>\$ (7,933)</u>	<u>\$ (4,008)</u>	<u>\$ (107,004)</u>
Effective federal income tax benefit rate	<u>(15.93)%</u>	<u>(12.45)%</u>	<u>(16.14)%</u>

The Company has tax NOL carryforwards and investment tax credit carryforwards that could be reduced or eliminated, or the amounts that can be utilized in any year could be limited, if certain events occur as a part of the Company's reorganization. Such events include, but are not limited to, debt forgiveness, the conversion of debt to equity or change in control of the Company. The occurrence of such events cannot be predicted and their effects on the Company's tax attributes, if any, cannot be

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

estimated until a reorganization plan is consummated. A summary of the Company's NOL carryforwards and investment tax credit carryforwards as of December 31, 1993, follows:

	<u>Tax Year Generated</u>	<u>Amount</u> (In thousands)	<u>Tax Year Expires</u>
Tax NOL carryforward:			
	1992	\$ 880	2007
	1991	62,127	2006
	1990	<u>31,996</u>	2005
		<u>\$ 95,003</u>	
Investment tax credit carryforward:			
	1990	\$ 5,652	2005
	1987	9,830	2002
	1986	11,415	2001
	1985	<u>144</u>	2000
		<u>\$ 27,041</u>	

The 1990 NOL carryforward above has been offset by the estimated taxable income for the year ended December 31, 1993 of approximately \$50 million.

The federal income tax returns of the Company for the years 1983 through 1989 have been examined by the IRS. The IRS has filed an amended proof of claim in the Bankruptcy Case of approximately \$53.7 million, including interest and penalties up to January 8, 1992. The Company has filed a motion with the Bankruptcy Court to approve a settlement reached with the IRS for such claims in the amount of \$6.5 million, including interest. The years 1990 through 1992 have not been examined and are not covered by the proof of claim filed. The Company believes that adequate provisions have been made through December 31, 1993 for the settlement amount and for any additional tax that may be due for open tax years.

On August 10, 1993, President Clinton signed tax legislation which, among other provisions, increases the corporate income tax rate to 35% retroactive to January 1, 1993. SFAS No. 109 requires that deferred tax liabilities and assets be adjusted in the period of enactment for the effect of an enacted change in tax laws or rates. The Company recognized a charge to earnings of \$3.4 million in the third quarter of 1993 to reflect the impact on net accumulated deferred income taxes related to such increase in the tax rate.

J. Commitments and Contingencies

Cash construction commitments, pursuant to ANPP Participation Agreement, for the Company subsequent to December 31, 1993 are primarily related to Palo Verde and total approximately \$46.8 million.

Arizona Transaction Privilege ("Sales") Tax

The Arizona Department of Revenue ("ADR") conducted an audit of the sales taxes paid on lease payments under the Palo Verde Leases during the audit period of August 1, 1988 through July 31, 1990. On March 10, 1992, the Company received copies of Notices of Proposed Assessment (the "Sales Tax Notices") issued by the ADR to each of the taxpayer owner trusts in care of the Owner Trustee.

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

The original proposed total deficiency assessments, which covered only the audit period, were approximately \$8.8 million, plus related interest thereon. On February 22, 1993, the ADR filed Notices of Jeopardy Assessment totaling approximately \$7.8 million, including interest through February 28, 1993, to convert the proposed deficiencies for the audit period into jeopardy assessments, which are immediately collectible. On February 23, 1993, the ADR filed Notices of Tax Lien in the Maricopa County Recorder's Office and with the Secretary of State of Arizona against the owner trusts' interests in Palo Verde. Under the Arizona tax statutes, the owner trusts can contest both the jeopardy assessment and the underlying assessment. Although the ADR can take action immediately to collect the alleged deficiency from the owner trusts, including collection action and foreclosure on the owner trusts' interests in Palo Verde, the ADR has taken no action in that regard. The ADR also may assert additional tax deficiencies for the period from August 1, 1990 through 1991, when the last lease payments were received by the owner trusts. The Owner Participants have informed the Company that the ADR has scheduled a hearing on April 11, 1994.

If the Owner Trustee or Owner Participants incur additional tax liability or other loss as a result of the assessments, the Owner Trustee and Owner Participants may have a claim against the Company for indemnification pursuant to the participation agreements and leases in the sale/leaseback transactions. The Owner Trustee and Owner Participants have filed proofs of claim alleging unliquidated amounts owed pursuant to the participation agreements and leases, which may encompass claims for indemnification. Pursuant to the settlement agreements entered into between the Company, the Owner Trustee and each Owner Participant in connection with the Plan, the Company's indemnity obligations under the participation agreements generally would continue in effect following the Effective Date, including any claim for indemnification as a result of this matter. See Note B. If the Owner Trustee fails to contest the jeopardy assessment or the underlying assessment, the Company would challenge the amount of any indemnification claim. The Company cannot predict the outcome of the underlying tax dispute or any claim for indemnification arising out of this matter.

Environmental Matters

The Company is subject to regulation with respect to air, soil and water quality, solid waste disposal and other environmental matters by federal, state and local authorities. These authorities govern current facility operations and exercise continuing jurisdiction over facility modifications. Environmental regulations can change at a rapid pace and cannot be predicted with certainty. The construction of new facilities is subject to standards imposed by environmental regulation and substantial expenditures may be required to comply with such regulations. Recognition in rates of the capital expenditures and operating costs incurred in response to environmental considerations will be subject to normal regulatory review and standards. The Company analyzes the costs of its obligations arising from environmental matters on an on-going basis and believes it has made adequate provision in its financial statements to meet such obligations.

Clean Air Act. In November 1990, the Clean Air Act Amendments of 1990 (the "Clean Air Act") became law. The Clean Air Act establishes new regulatory and permitting programs that will be administered by EPA or delegated to state agencies. Many provisions of the Clean Air Act will affect operations by electric utilities, including the Company. In particular, the following areas addressed in the Clean Air Act may have a significant impact on the Company: Title I dealing with nonattainment of national air ambient quality standards, Title IV dealing with acid rain, and Title V covering operating permits. In addition, provisions addressing mobile sources of pollutants and hazardous air pollutants may have a lesser impact on the Company's operations.

The Company has completed an initial evaluation of the impact of the Clean Air Act on the Company's operations and has developed a five-year plan beginning in 1993 to implement Clean Air

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

Act requirements on existing facilities. As part of the plan, the Company will make modifications to existing facilities at the Newman Power Station and the Rio Grande Power Station, including modifications to the steam generators and combustion turbines and the installation of continuous emissions monitoring equipment. The projected costs of these capital improvements are approximately \$5 million over the five-year period of the plan.

Rio Grande Power Station. The Company has notified New Mexico Environment Department ("NMED") of a spill of approximately 510 barrels of fuel oil which occurred at the Rio Grande Power Station in August 1986. The initial site assessment has been completed, a remediation plan has been submitted to NMED, and remediation is progressing under the plan. Potential clean-up costs are currently estimated to be less than \$500,000 to be incurred over the next five to ten years. The New Mexico Water Quality Act provides for a potential penalty of \$1,000 for each day of violation, which for a five-year period could result in a penalty of approximately \$2 million. The Company has been in close communication with the NMED and does not believe that a penalty of such magnitude will be assessed. The NMED has filed a proof of claim in the Bankruptcy Case reflecting an alleged obligation in an unspecified sum based on alleged ground water or soil contamination at the Rio Grande Power Station.

COL-TEX Refinery Site. In November 1991, the Company was notified by the Texas Natural Resources Conservation Commission ("TNRCC") that the Company had been identified as a potentially responsible party ("PRP") at the Col-Tex Refinery Texas Superfund Site in Colorado City, Mitchell County, Texas (the "Col-Tex Site"). The Col-Tex Site consists of approximately 25 acres located along the Colorado River immediately west of Colorado City, Texas. The Col-Tex Site was the location of several oil refining companies that owned and/or operated at the Col-Tex Site from the 1920s to the late 1960s.

The State of Texas, on behalf of the TNRCC, filed a proof of claim in the Company's Bankruptcy Case for remediation and oversight costs and requested that the claim be accorded administrative expense priority designation. The TNRCC's position is that the Company is a PRP and is, therefore, jointly and severally liable for the full cost of clean-up and oversight at the Col-Tex Site. The TNRCC has informed the Company informally that it estimates site assessment costs to be approximately \$3 million and the total clean-up costs to be approximately \$22 million. The Company disputes that it is liable as a PRP under applicable law. Accordingly, the Company has not agreed to participate in the assessment and remediation of the Col-Tex Site.

The Company also received notice on January 12, 1993 of the State's review of liability in connection with an expansion of the Col-Tex Site to an area referred to as Col-Tex II. The Company has been identified as a PRP in connection with this expanded site, but its position with respect to liability there is consistent with its position with respect to the Col-Tex Site.

The following entities have filed proofs of claim in the Bankruptcy Case related to potential claims for contribution in the event any of such entities has liability for remediation and oversight costs of the Col-Tex Site: ASARCO, Inc., Tesoro Petroleum Company, Fina Oil & Chemical Company and Missouri Pacific Railroad Company.

On November 24, 1993, a Joint Motion for Order Approving the Withdrawal of Proofs of Claim filed by the State of Texas was filed in the Bankruptcy Case by attorneys for the Company and the State of Texas. Fina Oil & Chemical Company filed an objection to the motion and, at this time, no action has been taken by the Bankruptcy Court.

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

Health Insurance Plan

The Company maintains a self-insurance program for that portion of health care costs not covered by insurance. The Company is liable for claims up to \$100,000 per employee or retiree annually, and aggregate claims up to approximately \$61 million annually. Self-insurance costs are accrued based upon the aggregate liability for reported claims and an actuarially determined estimated liability for claims incurred but not reported of approximately \$800,000. See Note L for a discussion of SFAS No. 106.

K. Litigation

Automatic Stay of Litigation Due to Bankruptcy

Upon the filing of the Company's bankruptcy petition, the provisions of the Bankruptcy Code operate as a stay applicable to all entities of, among other things, the commencement or continuation of judicial, administrative, or other actions or proceedings against the Company that were or could have been commenced before the bankruptcy petition was filed. This stay is subject to certain exceptions—criminal actions and actions by governmental units to enforce police or regulatory powers, for example, are not stayed. The Bankruptcy Court also has discretion to terminate, annul, modify or condition the stay.

P & C Lacelaw Trust Litigation

In September 1990, P & C Lacelaw Trust ("Lacelaw") filed suit in the 346th District Court of El Paso County, Texas, Cause No. 90-10139, against the Company, Franklin, and DDG, Inc. ("DDG"), the company that 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 allegedly 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 (i) a declaratory judgment that the Company is a general partner in the partnership; (ii) a judgment declaring Lacelaw's rights as a limited partner; (iii) an accounting of all financial transactions involving the partnership; and (iv) a dissolution of the partnership. Lacelaw alleges actual damages of \$3.2 million and punitive damages of at least \$10 million. The Company vigorously denies any liability with respect to this lawsuit and believes that the claims are without merit. Because of the automatic stay imposed as a result of the Company's bankruptcy filing, 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. Lacelaw has filed a proof of claim in the Bankruptcy Case asserting a general unsecured claim in excess of \$3 million based on the litigation, but has not attempted to lift the stay.

Plains Electric Generation and Transmission Cooperative Litigation

On December 12, 1991, Plains Electric Generation and Transmission Cooperative, Inc. ("Plains") filed suit in the United States District Court for the District of New Mexico, Cause No. CIV91-1199, against the Company alleging breach of a letter of understanding related to a potential option to purchase up to 50 MW of transfer capability in the AIP if certain enhancements could be made to the AIP to allow additional transfer capability. Plains seeks specific performance or, alternatively, compensatory and punitive damages in an unspecified amount for breach of contract, breach of implied covenant of good faith and fair dealing, breach of the New Mexico Unfair Practices

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

Act, and tortious conduct for not performing the terms of the letter of understanding. The Company filed an answer and counterclaim to the action on January 6, 1992, denying all allegations and asserting that any dispute should be subject to arbitration. The Company denies any liability with respect to the lawsuit and intends to defend the action vigorously. Due to the automatic stay imposed as a result of the bankruptcy filing, no discovery has been conducted in this case; therefore, the outcome of the suit and potential damages, if any, cannot be determined at this time. Plains has filed a proof of claim in the Bankruptcy Case for an unliquidated amount. The letter of understanding may or may not be an executory agreement that is subject to assumption or rejection under the Bankruptcy Code.

L. Benefit Plans

Pension Plan. The Company's Retirement Income Plan (the "Retirement Plan") covers employees who have completed one year of service with the Company, are 21 years of age and work at least a minimum number of hours each year. The Retirement Plan is a qualified noncontributory defined benefit plan. Upon retirement or death of a vested plan participant, assets of the Retirement Plan are used to pay benefit obligations under the Retirement Plan. Contributions from the Company are based on the minimum funding amounts required by the Department of Labor ("DOL") and IRS under provisions of the Retirement Plan, as actuarially calculated. The assets of the Retirement Plan are invested in equity securities, fixed income instruments and cash equivalents and are managed by professional investment managers appointed by the Company.

The Company's Supplemental Retirement and Survivor Income Plan for Key Employees ("SERP") is a non-qualified, non-funded defined benefit 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 Retirement Plan. Pursuant to an order of the Bankruptcy Court, the Company is authorized to pay and has paid each recipient the lesser of \$2,000 per month or the amount he or she otherwise would have received under the SERP from the Petition Date forward. The individuals have an unsecured prepetition claim against the Company for any amounts they would have received in excess of the \$2,000 per month. Pursuant to the Plan, the SERP would be assumed and the accumulated deficiencies to certain retirees would be paid. In addition, pursuant to the Merger Agreement, CSW would honor the terms of the SERP.

During 1993, the Company entered into early retirement agreements with five senior executives. The cost of these agreements in excess of amounts previously provided through the Retirement Plan and SERP was approximately \$4 million which was expensed in 1993 and included in the Non-Qualified Retirement Income Plans below.

Net periodic pension cost for the Retirement Plan and Non-Qualified Retirement Income Plans 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:

	<u>Years Ended December 31,</u>		
	<u>1993</u>	<u>1992</u>	<u>1991</u>
	(In thousands)		
Service cost for benefits earned during the period	\$ 6,114	\$ 2,165	\$ 1,698
Interest cost on projected benefit obligation	4,376	4,235	4,069
Actual return on plan assets	(1,769)	(1,914)	(6,808)
Net amortization and deferral	(1,245)	(653)	4,819
Net periodic pension cost	7,476	3,833	3,778
Amount deferred due to actions of the regulator	-	-	(294)
Net periodic cost recognized	<u>\$ 7,476</u>	<u>\$ 3,833</u>	<u>\$ 3,484</u>

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

The assumed annual discount rates used in determining the net periodic pension cost were 8.00%, 7.25% and 8.00% for 1993, 1992 and 1991, 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, 1993 and 1992 are presented below:

	<u>December 31,</u>			
	<u>1993</u>	<u>Non-Qualified Retirement Income Plans</u>	<u>1992</u>	<u>Non-Qualified Retirement Income Plans</u>
		(In thousands)		
Actuarial present value of benefit obligations:				
Vested benefit obligation	\$ (41,845)	\$ (7,545)	\$ (35,376)	\$ (6,024)
Accumulated benefit obligation	\$ (44,315)	\$ (8,993)	\$ (37,281)	\$ (7,446)
Projected benefit obligation	\$ (58,289)	\$ (10,523)	\$ (47,877)	\$ (8,915)
Plan assets at fair value	43,351	-	41,439	-
Projected benefit obligation in excess of plan assets	(14,938)	(10,523)	(6,438)	(8,915)
Unrecognized net (gain)/loss from past experience	6,414	2,239	(3,022)	2,869
Unrecognized prior service cost	816	(2,096)	906	(96)
Unrecognized transition obligation	3,265	348	3,673	452
Adjustment required to recognize minimum liability	-	-	-	(1,756)
Accrued pension liability	<u>\$ (4,443)</u>	<u>\$ (10,032)</u>	<u>\$ (4,881)</u>	<u>\$ (7,446)</u>

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

	<u>1993</u>	<u>1992</u>
Discount rate	7.25%	8.00%
Rate of increase in compensation levels	6.00%	6.00%
Expected long-term rate of return on plan assets	8.50%	8.50%

The Pension Benefit Guaranty Corporation has filed a proof of claim in the amount of approximately \$5.5 million based upon an assumed termination of the Retirement Plan effective June 15, 1992. The Company has not terminated the Retirement Plan, the Company has made all payments necessary to meet funding requirements and has no accumulated funding deficiency.

Other Postretirement Benefits. 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.

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions" ("SFAS No. 106"), 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, effective for fiscal years beginning after December 15, 1992. The Company adopted SFAS No. 106 as of January 1, 1993.

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. The Company has elected to amortize the transition obligation at January 1, 1993 of approximately \$43.4 million over 20 years.

Net periodic postretirement benefit cost for the year ended December 31, 1993 is as follows (In thousands):

Service cost for benefits earned during the period	\$ 1,564
Interest cost on accumulated postretirement benefit obligation	3,425
Amortization of transition obligation (based upon a 20 year period)	2,172
Net periodic postretirement benefits costs	\$ 7,161

The funded status of the plan and amount recognized in the Company's balance sheet at December 31, 1993 are presented below (In thousands):

Actuarial present value of postretirement benefit obligation:	
Accumulated postretirement benefit obligation:	
Retirees	\$ (23,358)
Actives	(30,008)
	<u>(53,366)</u>
Plan assets at fair value	<u>—</u>
Accumulated postretirement benefit obligation in excess of plan assets	(53,366)
Unrecognized net (gain)/loss from past experience	5,818
Unrecognized transition obligation	<u>41,267</u>
Accrued postretirement benefit liability	\$ (6,281)

For measurement purposes, a 15 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for 1994; the rate was assumed to decrease gradually to 6 percent for 2004 and remain at that level thereafter. The health care cost trend rate assumption has a significant effect on the amounts reported. To illustrate, increasing the assumed health care cost trend rates by 1 percentage point in each year would increase the accumulated postretirement benefit obligation as of December 31, 1993 by \$6.4 million and the aggregate of the service and interest cost components of net periodic postretirement benefit cost for the year ended December 31, 1993 by \$900,000.

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

Discount rate	7.25%
Rate of increase in compensation levels	6.00%

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

In 1992 and 1991, the Company expensed postretirement health care costs, under the pay-as-you-go method, of approximately \$900,000 and \$600,000, respectively.

M. Franchises and Significant Customers

Franchises. The Company's major franchises are with the Cities of El Paso, Texas, and Las Cruces, New Mexico. The franchises grant the Company the right to utilize public rights-of-way and to place its facilities and structures necessary to serve its retail customers within such cities. The franchise with the City of El Paso expires in March 2001 and does not contain renewal provisions. The Company is facing significant near term challenges in connection with certain of its New Mexico customers, including the City of Las Cruces and the military installations of White Sands Missile Range and Holloman Air Force Base.

The Company's twenty-five year franchise with the City of Las Cruces expired in March 1993. The Company and the City of Las Cruces entered into a one-year franchise while they continued negotiations related to a new long-term franchise. These negotiations have not resulted in a new franchise and the one-year franchise expired March 18, 1994. The Company has continued to provide electric service to customers in the City of Las Cruces, consistent with its view that the right and obligation to serve customers within the City of Las Cruces is derived from the New Mexico Public Utility Act, as well as other New Mexico law, and not from the franchise. The City of Las Cruces has acknowledged this obligation in a press release issued March 12, 1994. Sales to customers in the City of Las Cruces represented approximately 7% of the Company's operating revenue in 1993.

The City of Las Cruces is continuing its exploration and consideration of alternatives for electric service that may be available to it, including construction of its own distribution system and/or purchase or condemnation of all or a portion of the Company's distribution system and other property in the Las Cruces metropolitan area. In March 1993, the City of Las Cruces presented a proposal, which the Company rejected, to purchase the Company's facilities used to serve customers within the City of Las Cruces. Nevertheless, in January 1994, the City of Las Cruces issued two requests for proposals ("RFPs"), one with respect to the provision of a long-term supply of wholesale electric power and one with respect to operations and maintenance services for a distribution system in the City of Las Cruces. Proposals in response to the RFPs were due no later than February 28, 1994. The City of Las Cruces has not announced any decisions related to the RFPs or its intentions with respect to the development of a competitive distribution system in view of the Company's refusal to sell its distribution system. The Company did not respond to the RFPs, consistent with its position that the franchise agreement does not govern the right or obligation to provide electric service.

The Company and the City of Las Cruces are continuing discussions related to the provision of electric service to customers within the City of Las Cruces. The Company also is considering the level of franchise fees that should be paid if the franchise agreement is not replaced. The Company believes that it will continue to provide electric service to the City of Las Cruces for the immediate future, either under a franchise agreement or without an agreement in place, but pursuant to its right and obligation under New Mexico law. If the City of Las Cruces and the Company do not agree to a new franchise agreement and the City of Las Cruces attempts to change the provider of electric service, the Company will challenge such actions in the New Mexico Commission, the appropriate courts, or both.

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

On February 8, 1993, Southern Union Gas Company ("Southern Union") filed a request with the City of El Paso that Southern Union's present franchise to provide gas service be amended to permit Southern Union to provide electric service. Such proposed service would compete with service provided by the Company. The City of El Paso has not acted on Southern Union's request. Southern Union has not applied to the Texas Commission for a service territory CCN or a CCN to construct facilities, although such CCNs would be required in addition to the requested amendment to Southern Union's franchise. Currently, the Company holds the only franchise with the City of El Paso to provide electric service inside the City, as well as the only CCN from the Texas Commission authorizing electric service inside the City. The Company will oppose any request by Southern Union for a CCN to provide electric service inside the City of El Paso, but the Company cannot predict whether a CCN would be granted to Southern Union if one is requested from the Texas Commission or whether the City of El Paso will amend Southern Union's franchise.

The Company is a party to contracts with each of the United States Department of the Air Force ("Air Force") and the United States Department of the Army ("Army") regarding the provision of retail electric service at Holloman Air Force Base and White Sands Missile Range, respectively, located in New Mexico. The Company's sales pursuant to such contracts represented approximately 2% of revenues in 1993. The Company's right to provide this service was authorized by the New Mexico Commission in 1956 by the issuance of a CCN to the Company. The contract with the Army was due to expire on December 31, 1993 but has been extended by unilateral action of the Army for an indefinite period. The contract with the Air Force expired on February 28, 1994. The Company continues to provide the electric service under state approved tariffs and CCN authority. In 1993 the Army notified the Company that it intends to conduct a competitive bidding procedure to determine the provider of this electric service after expiration of the contract, but has taken no further action. On June 15, 1993, the Air Force issued an RFP from prospective electric utility service providers to provide electric service to Holloman Air Force Base upon expiration of its service agreement with the Company. Responses to the RFP were due August 12, 1993. The Company submitted its proposal to the Air Force on August 12, 1993 and filed a protest to the issuance and terms of the Air Force's RFP. The protest was upheld, but on technical grounds that have allowed the Air Force to proceed with the competitive bidding process, although it was delayed.

The Company believes that the procurement of retail electric service by the United States Department of Defense by such competitive procedures is prohibited by applicable federal procurement law and that participation by public utilities in such competitive procedures to attempt to obtain the right to provide this retail electric service would be contrary to New Mexico utility regulatory law and a violation of the Company's state-authorized right to provide this service. On April 1, 1993, the Company filed a Petition for Declaratory Order with the New Mexico Commission seeking, among other things, a declaration that the Company currently is the only public utility authorized under New Mexico utility regulatory law to offer and provide this particular retail electric service to Holloman Air Force Base and White Sands Missile Range. This proceeding has been docketed as New Mexico Commission Case No. 2505. The hearing examiner appointed to the case issued a report recommending that the New Mexico Commission determine that the case is not ripe for determination. In September, the Attorney General of New Mexico filed exceptions to the hearing examiner's recommended decision. The Attorney General has taken the position that the case is ripe for decision and has urged the New Mexico Commission to declare that utilities may not compete or contract to provide retail service to existing loads of another utility in a bidding process conducted outside of a proceeding before the New Mexico Commission. The New Mexico Commission has not yet issued its decision. Although the Company believes that it is more probable than not that it will continue to have the right and obligation to provide the retail electric service to the two military installations, there is no assurance that this will be the case.

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

On January 4, 1994, the Company filed an action against the Air Force and related parties in the United States District Court for the District of New Mexico seeking declaratory and injunctive relief, No. CIV 94-6. The action requests a preliminary injunction against the Air Force's competitive bid process for electric service at Holloman Air Force Base until the court determines whether the competitive bid process is contrary to federal law. The action also requests (i) a permanent injunction of competitive procurement of the retail electric utility service for Holloman Air Force Base from any public utility regulated under the New Mexico Public Utility Act, and (ii) a declaratory judgment that the competitive procurement of the retail electric utility service for Holloman Air Force Base currently provided by the Company from any public utility regulated under the New Mexico Public Utility Act using competitive procedures based on "lowest net cost of service" is prohibited by federal law because it is inconsistent with New Mexico law governing the provision of the service by public utilities. A hearing on the Company's request for a preliminary injunction has been scheduled before the United States District Court for April 18, 1994.

The Company believes that it will continue to provide electric service to the City of Las Cruces, Holloman Air Force Base and White Sands Missile Range for the immediate future. The Company also intends to pursue all available means, including litigation, to retain such customers for the long term and believes, but can give no assurance, that it will prevail in its efforts to retain such customers in the long term. If the Company is unable to do so, however, the Company intends to pursue all available regulatory and legal avenues to obtain the appropriate recovery of its stranded investment related to such customers.

Significant Customers. In 1993, 1992 and 1991, IID, a wholesale customer, accounted for approximately \$55.0 million, \$48.8 million and \$41.4 million or 10.1%, 9.3% and 8.9%, respectively, of operating revenue.

During 1993 the Company recorded revenues pursuant to its contract with CFE in the amount of approximately \$41.9 million. The obligations of CFE under the agreement are subject to continued budgetary authorization by the Ministry of Programming and Budgeting of Mexico for each calendar year. The amount of capacity in 1992 began at 80 MW and increased to 120-150 MW during 1992, and will continue at that level through the term of the agreement.

N. Financial Instruments

Statement of Financial Accounting Standards No. 107, "Disclosure about Fair Value of Financial Instruments" ("SFAS No. 107"), requires the Company to disclose estimated fair values for its financial instruments. The Company has determined that cash and temporary investments, its secured and unsecured debt which is included in liabilities subject to compromise, see Note H, and its preferred stock meet the definition of financial instruments. Cash and temporary investments carrying amounts approximate its fair value because of the short-term maturities of the investments. Based on discussion with its financial advisor in bankruptcy, the fair value of the other financial instruments depends upon the terms and conditions of a consummated plan of reorganization which will resolve certain uncertainties described in Notes A, B, C and H. These uncertainties preclude the Company from determining the fair value of these financial instruments during the pendency of its reorganization proceedings.

EL PASO ELECTRIC COMPANY

(DEBTOR IN POSSESSION AS OF JANUARY 8, 1992)

NOTES TO FINANCIAL STATEMENTS - (Continued)

O. Selected Quarterly Financial Data (Unaudited)

	1991 Quarters				1992 Quarters			
	1st	2nd	3rd	4th	1st	2nd	3rd	4th
(In thousands of dollars except for per share data)								
Operating revenues	\$ 122,236	\$ 134,561	\$ 151,441	\$ 135,356	\$ 121,985	\$ 124,762	\$ 150,316	\$ 127,697
Operating income	4,980	16,499	27,593	15,899	16,178	18,339	29,657	2,862
Income (loss) before reorganization items and cumulative effect of a change in accounting principle	(12,443) ⁽¹⁾	2,835	9,995	(11,648) ⁽²⁾	(1,986)	1,142	13,154	(14,122) ⁽³⁾
Reorganization items	(5,292)	(3,264)	(2,499)	(19,539) ⁽⁵⁾	(3,865)	(10,731)	(3,335)	(8,437)
Income (loss) before cumulative effect of a change in accounting principle	(17,735)	(429)	7,496	(31,187)	(5,851)	(9,589)	9,819	(22,559)
Cumulative effect of a change in accounting principle	(96,044) ⁽⁴⁾	—	—	—	—	—	—	—
Net income (loss) applicable to common stock	(113,779)	(429)	7,496	(31,187)	(5,851)	(9,589)	9,819	(22,559)
Net income (loss) per weighted average share of common stock before cumulative effect of a change in accounting principle	(0.50)	(0.01)	0.21	(0.88)	(0.16)	(0.27)	0.27	(0.63)
Cumulative effect of a change in accounting principle per weighted average share of common stock	(2.70)	—	—	—	—	—	—	—

- (1) Reflects the recognition of approximately \$7.8 million for the settlement and anticipated settlement of state income and other tax claims.
- (2) Reflects interest payments on unsecured and undersecured debt of approximately \$10.2 million.
- (3) Reflects lower volume of sales and a charge of approximately \$7.1 million resulting from DOE assessment.
- (4) Reflects the change in accounting for income taxes from the deferred method to the asset and liability method. See Note I.
- (5) Reflects the interim payments or accrual of approximately \$13.3 million for fees and expenses. In addition, reflects interim payments to holders of the Company's preferred stock of approximately \$1.4 million. See Note A.

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

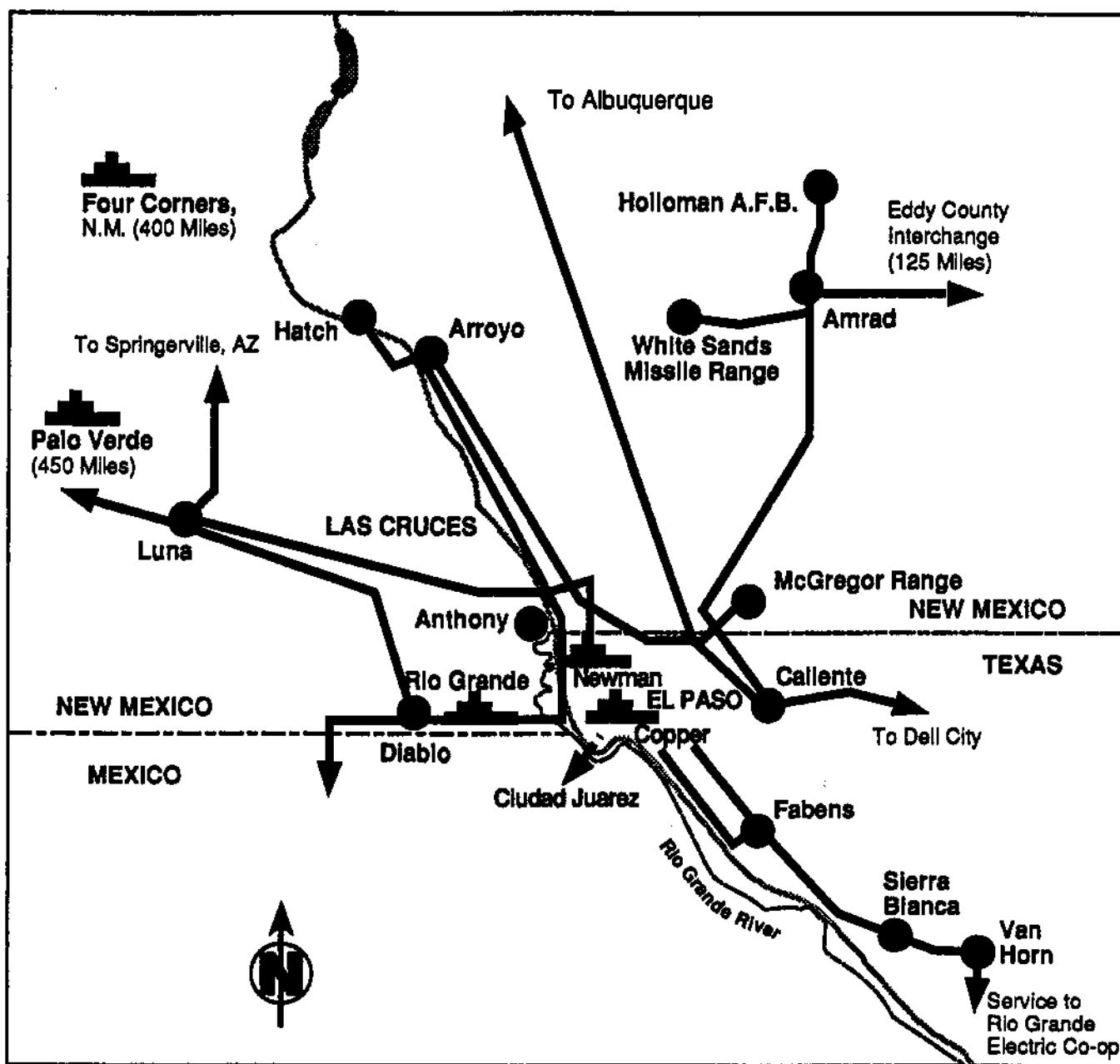
Not applicable.

PART III and PART IV

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

NOTES

EL PASO ELECTRIC SERVICE AREA

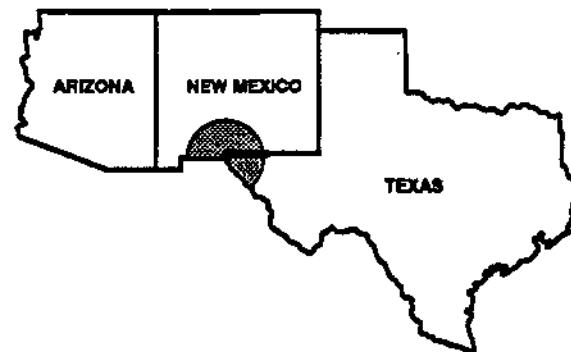


COMPANY LINES

MAJOR DISTRIBUTION STATIONS

GENERATING STATIONS

SERVICE AREA



El Paso Electric Company
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